# AUSTRALIA IN THE GLOBAL ECONOMY

2024

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# TOPIC 4

# ECONOMIC POLICIES AND MANAGEMENT

## Focus

**This topic focuses on the aims and operation of economic policies in the Australian economy and hypothetical situations.**

## Issues

**By the end of Topic 4, you will be able to examine the following economic issues:**

- Analyse the opportunity cost of government decisions in addressing specific economic problems or issues
- Investigate structural changes in the Australian economy resulting from microeconomic reforms
- Apply economic theory to explain how a government could address an economic problem or issue in hypothetical situations
- Analyse alternative ways to finance a budget deficit

## Skills

**Topic 4 skills questions can ask you to:**

- Explain how governments are restricted in their ability to simultaneously achieve economic objectives
- Use (simple) multiplier analysis to explain how governments can solve economic problems
- Identify limitations on the effectiveness of economic policies
- Explain the impact of key economic policies on an economy
- Propose and evaluate alternative policies to address an economic problem in hypothetical and the contemporary Australian contexts
- Explain, using economic theory, the general effects of macroeconomic and microeconomic policies on an economy
- Select an appropriate policy mix to address a specific economic problem

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## Topic 4

# Introduction

The first three topics of this book examined how Australia fits into the global economy and the kinds of economic issues that confront the Australian economy. This final topic examines *Economic Policies and Management* – looking in particular at the policies that can be used to address Australia's economic problems.

In this section we examine both the theory and practice of economic management. Each chapter examines the theory behind the policy, reviewing how economic policies can operate in hypothetical situations. We then examine the **current policy environment** in Australia, including recent Australian policies and alternative approaches.

Chapter 13 In studying economic policy, it is important to remember that there is always a reason why a government implements or changes a policy. In other words, all economic policies are related to policy objectives. Chapter 13 examines policy objectives in Australia and the potential conflicts in objectives that a government may face in implementing the economic policy mix.

In deciding which policies to implement, governments choose between a range of policy alternatives. In general terms, a distinction can be made between the government's use of macroeconomic policies, which are the broad policies that have overall impacts on the economy, and microeconomic policies, which are the policies designed to improve the operation of individual sectors and industries. The following chapters are divided between a discussion of macroeconomic and microeconomic policy instruments.

Chapters 14 and 15 These two chapters examine macroeconomic policy in Australia – fiscal policy and monetary policy – and how they can be used by the government to achieve its economic objectives.

Chapters 16 and 17 These two chapters look at microeconomic policies, with a focus on labour market policies in chapter 17.

Chapter 18 The book concludes with an evaluation of how well these policies achieve their objectives. Like all kinds of economic decisions, economic management involves making difficult choices between competing aims. Because of the difficulty in achieving all policy objectives, governments must prioritise their goals and respond to changing conditions in the global economic environment. Australia has achieved many of its economic policy objectives during the past 50 years. However, Australia still faces a range of longer term, structural problems and may face difficulty in sustaining its recent successes over time.

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# The Objectives of Economic Policy 13

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**13.2** The objectives of economic management
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**13.4** Conflicts in government policy objectives
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## 13.1 Introduction

In managing an economy, the first priority for a government is to determine what it will pursue as its economic objectives. Governments can choose to pursue a range of policy goals, and often the priorities of government policy shift over time.

Economists have traditionally described the major objectives of economic management in the following three ways:

- **Economic growth:** An increase in the level of goods and services produced in an economy, which increases the number of material wants satisfied and raises the living standards of individuals in the economy.
- **Internal balance:** Pursuing the goals of price stability (low inflation) and full employment.
- **External balance:** Keeping the current account deficit, foreign liabilities and exchange rate at stable and sustainable levels.

In the following pages we review the main objectives of government policy generally, and then discuss the current objectives of economic management in Australia.

## 13.2 The objectives of economic management

### Economic growth and wellbeing

Economic growth involves an increase in the volume of goods and services that an economy produces. It is measured by the **annual rate of change in real GDP**, that is, the percentage increase in the value of goods and services produced in an economy over a period of one year, adjusted for the rate of inflation.

Economic growth offers substantial benefits to a nation, including:

- an increased standard of living for the population
- improved job prospects for the labour force
- the opportunity for increased public investment in infrastructure and services such as education funded through higher government tax revenues.

Economic growth also contributes to the general **wellbeing** of households, or **quality of life**, because it means there are more resources available for important contributors to quality of life, such as health care, education and programs to support the natural environment.

**Quality of life** refers to the overall wellbeing of individuals within a country according to their material living standards and a range of other indicators, such as education levels, environmental quality and health standards.

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## Full employment

The objective of full employment involves the full use of all resources (land, labour, capital and enterprise), but economists generally focus on the full employment of labour. This is because when labour resources are not fully utilised, some people will be unemployed – resulting in significant social and economic problems.

The **non-accelerating inflation rate of unemployment (NAIRU)** refers to the level of unemployment at which there is no cyclical unemployment, that is, where the economy is at full employment.

Full employment does not mean that there is no unemployment. Rather, it means that the economy is at its **non-accelerating inflation rate of unemployment (NAIRU)**, otherwise known as the natural rate of unemployment. The concept of the NAIRU reflects the fact that there is always going to be a certain level of frictional, seasonal, structural and hard-core unemployment in the economy. The natural rate of unemployment is therefore the level of unemployment that remains after the elimination of cyclical unemployment – the unemployment caused by the upturns and downturns of the economic cycle. This means that the NAIRU is caused by supply side factors rather than deficiency in demand.

The government can reduce unemployment to its non-accelerating inflation rate through successful implementation of macroeconomic policies. It may also use microeconomic policies to reduce the NAIRU over the longer term. (*The different types of unemployment were discussed in more detail in chapter 8*).

The benefits of achieving full employment, or minimising unemployment, can be summarised as follows:

- fully utilising the economy's current capacity to produce, and therefore increasing living standards
- minimising the adverse economic and social problems associated with unemployment (for example, personal and family problems, loss of workforce skills and greater inequality).

## Price stability

Price stability refers to keeping inflation, or the sustained increase in the general price level, at an acceptable level. This does not mean that the government aims to eliminate inflation altogether; instead, it aims to sustain inflation at a level that will cause minimal distortion to the economy.

High inflation was a significant problem for advanced economies in the 1970s and 1980s. Until 2022, recent decades had seen inflation remain at low levels. In Australia, the Government and the Reserve Bank are committed to sustaining the average rate of inflation at 2–3 per cent over the course of the business cycle. (*This objective, as well as the causes of inflation, were discussed in more detail in chapter 9*).

Inflation is seen as a problem because of its economic consequences. A high level of inflation may:

- reduce the real value of income and wealth
- reduce our international competitiveness, due to rising costs of production
- cause a depreciation in the exchange rate
- create uncertainty about future costs and distort economic decision making
- distort the pattern of resource allocation by encouraging speculation in relatively unproductive activities and discouraging savings and investment in productive activities that contribute to higher output.

## External stability

Achieving external stability involves a country meeting its long-term financial obligations to the rest of the world so that its external accounts do not hinder internal economic goals such as higher growth and lower inflation. As discussed in chapter 10, this is also known as achieving "external balance". Commonly used measures of external stability include:

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- Achieving a sustainable position on the **current account** of the **balance of payments**. This means, over the long term, balancing our payments for imports of goods and services, as well as other income payments, with our receipts for exports of goods and services, as well as other income receipts.
- **Net foreign debt as a percentage of GDP**. Foreign debt should be kept at a level where an economy can afford to make interest payments on its debt, most often measured via the debt-servicing ratio – the percentage of export revenue that is spent on making interest payments on foreign debt.
- **Terms of trade**. This reflects the relative prices of Australia's exports and imports. An increase in the terms of trade improves external stability because it indicates that Australia is able to buy more imports with a given quantity of exports.
- **Exchange rate**. In the short term, the exchange rate is a measure of international confidence in the Australian economy. High volatility in the exchange rate may indicate a lack of external stability.
- **International competitiveness**. Improving Australia's international competitiveness is the best way to maintain external stability over time.

**Current account** is the part of the balance of payments that shows the receipts and payments for trade in goods and services, as well as both primary and secondary income flows between Australia and the rest of the world in a given time period. These are non-reversible transactions.

**Balance of payments** is the record of the transactions between Australia and the rest of the world during a given period, consisting of the current account and the capital and financial account.

Although Australia has had large external imbalances, during recent decades this has not been a major concern for the Australian economy. Nevertheless, improving external imbalances is a policy goal as lower external imbalance will mean reduced vulnerability to adverse developments in the global economy.

## An equitable distribution of income and wealth

An overall objective of government policy is to create a fairer **distribution of income and wealth** in the economy. Governments generally accept that when free markets operate without government intervention, they will produce unfair outcomes because some individuals and some groups in society have fewer opportunities than others.

While governments do not aim to remove all of the inequalities between individuals, it is widely agreed that societies should make provision for the needs of people who are not able to provide for themselves – such as aged persons, people with disabilities or illnesses, and people who are unable to find work. Government policies also generally aim to reduce some of the gap between higher and lower income earners through redistribution policies – such as higher tax rates for high income earners, and social security payments for lower income earners, especially those with families to look after. To address the problem of poverty or social disadvantage passing from one generation to the next, government policies also aim to improve opportunities for all Australians to achieve their potential through access to education and other opportunities. Specific policies such as these are often needed to address specific areas of inequality, alongside macroeconomic policies to increase economic growth, keep inflation low and reduce unemployment.

## Environmental sustainability

In the process of achieving a society's economic objectives, economic activity may create side effects such as pollution and the depletion of natural resources. In order to address these problems, governments may sometimes establish specific environmental objectives, such as a reduction in greenhouse gas emissions, an improvement in energy efficiency, a reduction in the use of old-growth forests for the timber industry, or a reduction in waste and pollution.

Environmental objectives are part of the government's overall framework of economic management, and a substantial amount of money is spent by Commonwealth and State governments on environmental programs. Traditionally, governments have been willing to trade off some longer-term environmental objectives in favour of the benefits of increased economic activity in the short term. However, with growing recognition of the serious impacts of economic activity on climate change, **ecologically sustainable development** has become an increasingly important economic objective.

**Ecologically sustainable development** involves conserving and enhancing the community's resources so that ecological processes and quality of life are maintained.

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## reviewquestions

1 Describe the Government's economic objectives of internal stability and economic growth.

2 Discuss how effective you believe the Australian Government has been in achieving external stability in recent years. Has this goal conflicted with other economic objectives?

# 13.3 The goals of government policy in 2024

Although the broad objectives of economic policy remain largely the same from one year to the next, over time some objectives become higher priorities while other goals become less important. Changing economic conditions influence which goals receive the highest priority at different times. The election of a new government or Prime Minister, as occurred in 2022, can sometimes lead to significant changes in economic priorities. This section examines the current objectives of economic policy in Australia.

### Containing inflationary pressures

After three decades of low inflation, price pressures re-emerged as the Australian economy recovered from the COVID-19 recession. This makes containing inflation the highest short-term priority of economic policy. As inflation surged to 6 per cent in 2022–23, the Reserve Bank implemented the most aggressive tightening cycle since the Reserve Bank was granted formal independence. While monetary policy plays the central role in achieving the goal of low inflation, fiscal policy also plays a role. The 2023–24 Budget included measures to contribute to lower inflation by reducing energy costs for households, although some economists argued that this positive effect would be outweighed by some of the cost-of-living measures, including an increase in JobSeeker payments, adding to domestic demand.

### Fiscal consolidation

In response to the COVID-19 pandemic, the Government undertook unprecedented spending to ensure minimal disruption to the economy, while protecting the public health. At the time of the 2021 Intergenerational Report, the Budget was forecast to stay in deficit until 2060. However, this outlook has since improved, with a surge in commodity prices leading to a one-off budget surplus for 2022–23, the first surplus in 15 years. With the budget returning to deficit in 2023–24, fiscal consolidation remains a major medium-term priority for the Albanese Government. Measures to increase revenue include increasing tax on multinational companies and funding an Australian Tax Office taskforce to crack down on tax avoidance.

### Transition towards "net zero" emissions

One of the major economic challenges confronting all economies is to accelerate their transition away from relying on fossil fuels, which are chiefly responsible for climate change. Australia is a large emitter of greenhouse gases on a per-capita basis, and policy settings relating to emission reductions have been uncertain and constantly changing over the past two decades. Concern about climate change was a significant factor in the election of the Labor Government in 2022. After it came to office, the Government legislated a commitment to reduce carbon emissions by 43 per cent on 2005 levels by 2030 and achieve "net zero" emissions by 2050. The process of transforming Australia's economy in

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the years ahead will involve changes in every aspect of the economy, including industry structure, skills training, exports and regional development policy. Although in the past the transition to net zero was seen as involving a trade-off between environmental and economic policy goals, this is much less true now. With an emerging consensus among economists, business, and other interest groups, there is agreement that this transition is necessary and provides many opportunities for new industries to emerge.

### Maintaining low unemployment

Australia has sustained low rates of unemployment in recent years. Unemployment fell to a low of 3.4 per cent in October 2022, its lowest level in almost 50 years, reflecting both the strength of Australia's post-COVID recovery and ongoing restrictions to migration which, in the short term, led to shortages of workers becoming a larger challenge than shortages of jobs. Governments implement a wide range of policies to improve skills, increase workforce participation and ensure that the labour market operates efficiently. Government policy in 2024 is focused on preventing high levels of inflation becoming entrenched, which in the longer term would threaten the goal of sustainable economic growth and low unemployment.

### Increasing Australia's productivity and sustainable rate of long-term growth

A major focus of the policy mix over the past four decades has been to implement structural changes that will support a higher rate of long-term economic growth (which has fallen since the 1990s). This requires measures to improve productivity growth, increase workforce participation and address capacity constraints in the economy (related to inadequate infrastructure and shortages of skilled workers). Higher productivity growth has become a high priority because Australia's ageing population is likely to reduce Australia's labour force participation rate in coming years, threatening to reduce Australia's sustainable rate of economic growth. The Productivity Commission's 2023 "Advancing Prosperity" Inquiry identified that productivity in the services sector, which makes up 80 per cent of the economy and 90 per cent of the workforce, has lagged behind global counterparts. The Productivity Commission identified the need for policy changes to support education, skilled migration and the labour market to boost productivity. Improved productivity is also a key objective for state and federal government investment in physical infrastructure projects including roads, public transport, water and ports. Some of the Government's policies aimed at boosting the country's productive capacity include fee-free TAFE courses, cheaper and more accessible child care, and investing in infrastructure such as the National Broadband Network and the digital economy.

### Improving distribution of income and wealth

Improving the distribution of income and wealth has been a long-term objective of policy that influenced several policy changes in the past decade. These include education funding reforms (to assist disadvantaged schools), welfare changes (such as increases in the age pension) and the National Disability Insurance Scheme, which reduces out-of-pocket expenses for people with significant disabilities.

Protecting vulnerable groups was a major consideration in the design of policies responding to the economic downturn caused by COVID-19. Besides the JobKeeper wage subsidy program, the Government also temporarily doubled the unemployment benefit and made it easier to access. More recent policy measures by the Government to reduce inequality included increasing wages for low-income earners (through an increase in the minimum wage), extending Parenting Payment (Single) to parents with children up to 14 years (previously 8 years), increasing investment in social housing and introducing new health, education and employment programs to assist with the goal of Closing the Gap between Indigenous and non-Indigenous Australians.

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## reviewquestions

1 Outline the long-term objectives of government policy.
2 Briefly outline how successful Australia has been in recent years in achieving each of the economic goals listed above.

# 13.4 Conflicts in government policy objectives

Governments face significant conflicts in seeking to achieve the goals of economic growth, low inflation, low unemployment, environmental sustainability and external balance simultaneously. In attempting to achieve one goal, the government may limit its ability of achieving another. There are three major conflicts between the government's economic objectives:

### 1. Achieving a simultaneous reduction in unemployment and inflation

It is often argued that the government faces a trade-off between lower unemployment and inflation in the short to medium term. Stronger aggregate demand creates jobs and reduces unemployment, but is also likely to put upward pressure on prices. Weaker aggregate demand forces businesses to restrain price rises, but also tends to increase unemployment. The **Phillips curve**, shown in figure 13.1, shows this inverse relationship between inflation and unemployment, highlighting the trade-off that governments face when making policy decisions. However, this relationship is not necessarily symmetrical. A 2021 Reserve Bank research paper found strong evidence that the Phillips curve was actually flatter at higher levels of unemployment. That is, when unemployment is high, wages growth (and therefore prices) is largely unresponsive to changes in unemployment. However, wages growth becomes increasingly responsive to unemployment when it is at lower levels.

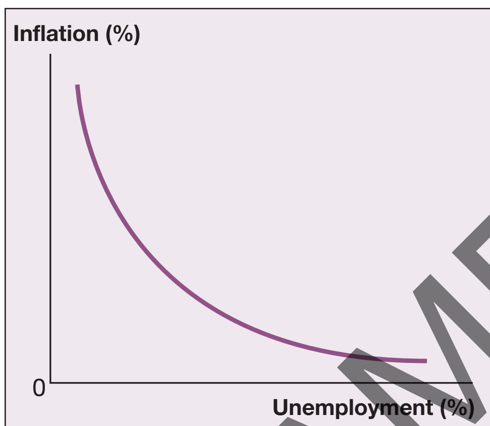


**Figure 13.1 –** The Phillips curve

**Appendix B:** Advanced Economic Analysis at the back of this textbook looks at the Long Run Phillips Curve – a more sophisticated analysis of the relationship between unemployment and inflation.

Australia's economic policymakers faced a Phillips curve trade-off between inflation and unemployment objectives in 2023. In a speech in June 2023, Michele Bullock, the (then) Deputy Governor of the RBA, said that the unemployment rate would need to rise from 3.6 per cent to 4.5 per cent to help bring inflation down to the bank's target range of 2 to 3 per cent.

### 2. Achieving economic growth and environmental sustainability

The pursuit of greater economic growth can come at the cost of environmental damage. Approving new developments or land clearing in environmentally sensitive areas for housing or agriculture can reduce forestation, disrupt habitats and endanger species of floral and fauna. Land and water resources can be degraded by excessive or inappropriate farming practices. Greater economic activity can cause pollution and an increase in waste. The goal of reducing carbon emissions has become more central to policy making all across the world in recent years, because of the importance of reducing carbon emissions to long-term economic growth. While Australia continues to face many conflicts between economic and environmental objectives, in the longer term, achieving economic and environment objectives can (and must) be done simultaneously. For example, recent economic research has found that acting on climate change early has the potential to lift GDP growth and create new jobs in clean energy industries.

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### 3. Achieving economic growth and external balance

The government also faces the challenge of managing conflicts between economic growth and external balance. Strong economic growth often results in a deterioration in the current account on the balance of payments. Higher economic growth is usually associated with increased consumption and investment, which will cause the volume of imports to rise. This is known as the **balance of payments constraint**, which refers to the limitation on the rate of growth because of the impact of high growth on the current account deficit.

The **balance of payments constraint** reflects the extent to which a high current account deficit limits the speed at which the economy can grow.

## AUSTRALIA'S FIRST WELLBEING BUDGET

Treasurer Jim Chalmers announced a significant shift in long-term economic policy goals in July 2023 when he introduced a new framework for measuring economic and social wellbeing. Traditionally, the Australian Treasury's reporting on the economy has focused on measures such as growth, inflation and unemployment. The new framework, set out in the *Measuring What Matters* paper, identifies 50 indicators that provide a broader measure of prosperity.

Of these 50 indicators:

- 20 show trend improvement over time, including life expectancy, experience of discrimination, trust in other people, and waste generated per person.
- 12 show a trend deterioration, including biological diversity, productivity, homelessness and trust in national government.
- The remaining 18 show mixed outcomes or are largely unchanged, such as life satisfaction, the proportion of people experiencing high or very high levels of psychological distress, and income and wealth inequality.

The development of a wellbeing framework in Australia follows in the footsteps of Scotland, Wales, Canada, New Zealand and Germany. These frameworks can influence policy outcomes by guiding policymakers to consider the interaction between economic goals and broader measures of prosperity and sustainability.

The Government plans to update the framework's online dashboard of indicators annually, though a decision is yet to be made on how often a reporting statement will be released. While some economists questioned whether the reporting framework would lead to actual policy changes, it reflects the way in which governments increasingly see our traditional economic objectives as a means to an end, and not just as ends in themselves.

"The measures are in addition to, not instead of, the more traditional ways we measure our economy like GDP, employment, inflation and wages.

The Government's primary focus is addressing inflation and laying the foundations for future growth but it is important that we simultaneously work on better aligning our economic and social goals … Measuring What Matters is part of a deliberate effort to put people and progress, fairness and opportunity at the very core of our thinking about our economy and our society, now and into the future."

*– Dr Jim Chalmers, Treasurer, July 21 2023 (media release)*

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### Other conflicts in objectives

The pursuit of economic growth can sometimes come at the cost of **greater inequality** in income distribution. Economic reforms may have negative social effects, such as relying on road tolls and other user-pays charges for public services, which can have negative distributional consequences for people on lower incomes. Decentralisation and deregulation of the labour market may have positive impacts on labour productivity and economic growth, but also increase wage dispersion and contribute to inequality. While growth and inequality are often viewed as conflicting objectives that governments must choose between, economists have recently developed "inclusive growth" principles, which suggest that sharing economic gains more evenly actually helps the economy grow. Giving children in poverty greater educational opportunities has positive social outcomes and improves the labour market in the future. Increasing female representation in business leadership positions is associated with higher levels of firm productivity. Achieving a more equitable distribution of income and wealth is a long-term challenge for government policy.

The government also experiences a range of other policy conflicts between **shorter-term** and **longer-term** objectives. The conflicts between short- and long-term objectives result from the fact that the policies aimed at long-term goals often involve significant structural change

and substantial costs in the shorter term, such as an increased level of unemployment or additional costs to the government. Governments may often be more focused on short-term objectives because of political considerations such as avoiding unpopular policies, rather than long-term objectives that may not deliver benefits for some time.

## reviewquestions

1. Briefly outline which economic objectives can be achieved simultaneously, that is, where the government does not face a conflict.
2. Describe TWO possible conflicts between the economic objectives of the government.
3. Using a diagram, explain the conflict between the government's internal stability objectives.

# 13.5 The economic policy mix

**Economic policy mix** refers to the combination of macroeconomic (fiscal and monetary) and microeconomic policies used by the government to achieve its economic objectives.

Governments have a variety of policy instruments that can be used to achieve their objectives. In a general sense, the instruments of economic policy are divided between macroeconomic and microeconomic policies.

- **Macroeconomic policies,** such as government budgets and changes in the level of interest rates, have an impact on the overall level of economic activity. These policies tend to influence the level of aggregate demand in the economy.
- **Microeconomic policies** involve specific measures to improve the operation of firms, industries and markets, by achieving change at the level of individual firms and industries. These policies tend to influence the aggregate supply of the economy – that is, improving productivity and efficiency so that the overall level of supply may be increased.

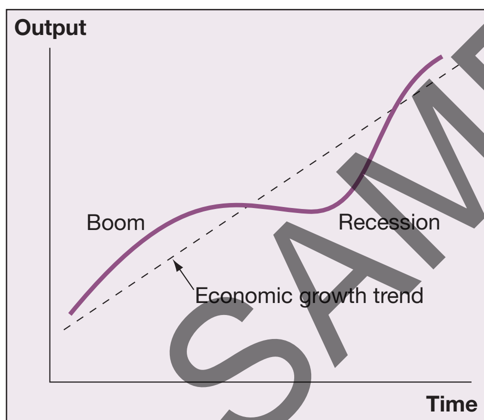


**Figure 13.2 –** The business cycle

Governments normally use a combination of macro and micro policies in order to best achieve their economic objectives. This combination of policies is called the **economic policy mix**, a term which is intended to capture the overall impact of the range of macro and micro policy measures implemented. The 2023 review of the Reserve Bank of Australia recommended that the RBA and Treasury establish a research program to investigate the optimal policy mix between monetary and fiscal instruments.

## Macroeconomic policy

The main role of macroeconomic policy is to manage the business cycle (changes in the level of economic activity). The level of economic activity is never constant. Economies are subject to the ups and downs of the business cycle, caused by changes in the level of aggregate supply and demand. This is shown in figure 13.2.

**Macroeconomic management** refers to the use of government policies to influence the economy with the aims of reducing large fluctuations in the level of economic activity and achieving certain economic goals.

Government **macroeconomic management** is designed to minimise these fluctuations so that economies experience low rates of inflation and unemployment, and relatively stable economic growth. Macroeconomic management can be defined as the use of government policies to influence the economy with the aims of reducing large fluctuations in the level of economic activity and achieving certain economic goals.

Government policies can help to **stabilise** the level of economic growth by smoothing the peaks and troughs of the economic cycle. This is why macroeconomic policies are also referred to as **counter-cyclical policies**. During periods of fast economic growth, it may be necessary to reduce the level of economic activity to avoid excessive inflation or a

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blowout in the current account deficit. Governments can increase the level of tax, reduce spending or the Reserve Bank of Australia can raise interest rates in order to reduce the level of economic activity:

- Higher tax rates will reduce consumers' disposable income and reduce the level of spending and aggregate demand, also reducing pressures on inflation and the current account deficit.
- Reduced government spending will also lower the level of aggregate demand by lowering the level of aggregate expenditure in the economy.
- Higher interest rates make borrowing money less attractive and will discourage borrowing and spending by both consumers and businesses.

On the other hand, when the economy experiences a downturn in economic growth, such as during the COVID-19 recession, a government may use macroeconomic policy to stimulate economic activity and raise the level of aggregate demand. This may be done through increased government spending, tax cuts and reductions in the level of interest rates.

One of the major lessons of Australia's economic performance over recent decades is that macroeconomic policy is not enough to achieve complex policy goals. Macroeconomic policy works effectively in either stimulating or dampening the economy in the short term, but it is much less effective in dealing with longer term problems such as low productivity growth, entrenched underemployment, inequality, weak international competitiveness, a low level of national savings or the need to reduce carbon emissions. However, macroeconomic and microeconomic policies can be effective when used together.

## Microeconomic policy

**Microeconomic policy** is action taken by government to improve resource allocation between firms and industries, in order to maximise output from scarce resources. Microeconomic policies are central to the government's long-term aim of addressing potential constraints on growth such as inflation and external imbalance.

**Microeconomic policy** refers to policies that are aimed at individual industries, seeking to increase aggregate supply by increasing the efficiency and productivity of producers.

Microeconomic policy over recent decades has reflected a change in the focus of economic management from influencing demand towards measures to influence supply. This economic strategy is known as **supply-side economics**. As governments have wrestled with the limited effectiveness of macroeconomic policies that mainly influenced the level of demand, they have turned to policies that focus on increasing the aggregate supply level by improving the competitiveness, productivity and efficiency of Australian industries, and raising workforce participation.

Microeconomic policy involves a range of specific policies varying from practices in individual government departments to policies for entire industries. The overall aim of microeconomic reforms is to **encourage the efficient operation of markets** and increase aggregate supply – by raising productivity, making the economy more adaptable to change and encouraging Australian producers to take on "world best" practices. The role of these policies is discussed in chapter 16.

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## reviewquestions

1. Distinguish between the roles of macroeconomic and microeconomic policies in the government's policy mix.
2. Discuss how macroeconomic policy responds to changes in the business cycle.

# chapter summary

1. The main **objectives of economic management** are economic growth, low inflation, full employment, external balance, an equitable distribution of income and wealth, and environmental sustainability.
2. **Economic growth** involves an increase in the volume of goods and services produced in an economy over a given time period, measured by the rate of change in real GDP. Growth is generally considered to be the highest priority of economic management because of its relationship to improved living standards.
3. An economy is considered to be at **full employment** (or the non-accelerating inflation rate of unemployment) when cyclical unemployment is eliminated.
4. **Price stability** refers to keeping inflation, or the increase in the general price level, at a reasonable level. This is currently reflected in the Reserve Bank's target of an average of 2–3 per cent inflation over the course of the economic cycle.
5. **External stability** refers to a situation where Australia is meeting its financial obligations to the rest of the world and its external accounts – its current account outcomes and foreign liabilities do not hinder it from achieving other economic objectives.
6. The Government's shorter-term economic priorities in 2024 are to contain inflationary pressures while keeping unemployment low, increase Australia's productive capacity and accelerate Australia's transition to a less carbon intensive economy.
7. The main long-term aims of economic policy are to increase productivity growth to improve international competitiveness and the long-term sustainable growth rate of the economy, increasing the overall level of national savings, and promoting environmental sustainability.
8. **Conflicts** exist among the objectives of economic management, such as between keeping inflation low and achieving full employment, and between achieving faster economic growth and promoting environmental sustainability.
9. **Macroeconomic policies**, such as fiscal and monetary policies, attempt to reduce fluctuations in the business cycle by influencing the level of aggregate demand.
10. **Microeconomic policies** are aimed at promoting structural change by influencing the supply side of the economy. By improving productivity and workforce participation, microeconomic policies aim to raise Australia's sustainable rate of growth over time.

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# chapter review

1. Explain why economic growth plays a central role in a government's policy objectives.
2. Discuss how the Australian Government's economic growth objectives have changed in recent years.
3. Distinguish between internal balance and external balance.
4. Identify how the Reserve Bank of Australia attempts to achieve price stability.
5. Explain why Australia's economic policy objectives have changed in recent years.
6. Examine how the objectives of reducing inequality in the distribution of income and wealth and improving environmental sustainability objectives are related to the objective of increasing economic growth.
7. Discuss the current priorities of economic management.
8. Explain why the goals of low inflation and low unemployment are considered to be conflicting aims of economic management.
9. Distinguish between macroeconomic and microeconomic policy, with reference to the concepts of aggregate demand and aggregate supply.
10. Explain how the concept of sustainable economic growth represents a balance between the government's conflicting policy goals.

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# 14 Fiscal Policy

**14.1** The meaning of fiscal policy
**14.2** Budget outcomes
**14.3** Changes in budget outcomes
**14.4** Methods of financing a deficit
**14.5** The current stance of fiscal policy
**14.6** The impact of recent fiscal policy

## 14.1 The meaning of fiscal policy

**Fiscal policy** is a macroeconomic policy that can influence resource allocation, redistribute income and reduce the fluctuations of the business cycle. Its instruments include government spending and taxation and the budget outcome.

**Fiscal policy** is at the heart of the management of the economy. Although it generally plays a less important role than monetary policy in influencing economic growth, fiscal policy can influence the overall level of economic activity and have a targeted impact on specific sectors of the economy such as individual industries or parts of society.

Fiscal policy involves the use of the Commonwealth Government's Budget in order to achieve the government's economic objectives. By varying the amount of government spending and revenue, the government can alter the level of economic activity, which in turn will influence economic growth, inflation, unemployment and the external indicators in the economy.

Further, changes in government spending and revenue collection can also lead to a **reallocation of resources**, which changes the pattern of production in the economy, as well as **redistributing income** within the community.

**The Budget** is the tool of the government for the exercise of fiscal policy. It shows the government's planned expenditure and revenue for the next financial year.

The **Budget** is the annual statement from the Australian Government of its income and expenditure plans for the next financial year. It is normally released in May. The Budget includes all forms of **revenue** received by the Government, including both taxation and other revenue:

- direct tax (personal income tax and company tax)
- indirect tax (such as customs and excise duties and the Goods and Services Tax)
- other revenues (such as dividends from public trading enterprises).

The other side of the Budget is government expenditure. The major items of expenditure in the Budget are social welfare, health, education, general public services and defence.

In some years, governments make major policy changes in response to changing economic or political conditions. Although most policy changes are announced in the Budget, governments also usually make a series of smaller policy changes at other times. Governments attract more public attention (and therefore political advantages) when the spread out "good news" announcements such as new spending programs over a period of weeks or months before the Budget. On the other hand, "bad news" announcements such as tax increases or spending cuts will often be bunched together in the Budget.

SAMPLE PAGES

When governments make smaller changes to fiscal policy throughout the course of the year, the full costings of these decisions are set out afterwards, either in the next Budget, or in a statement released around December each year, known as the Mid-Year Economic and Fiscal Outlook statement (or MYEFO). This statement also provides updates to the Treasury's forecasts for the Budget and future economic conditions. Changes in economic conditions can significantly affect planned revenues and expenditures.

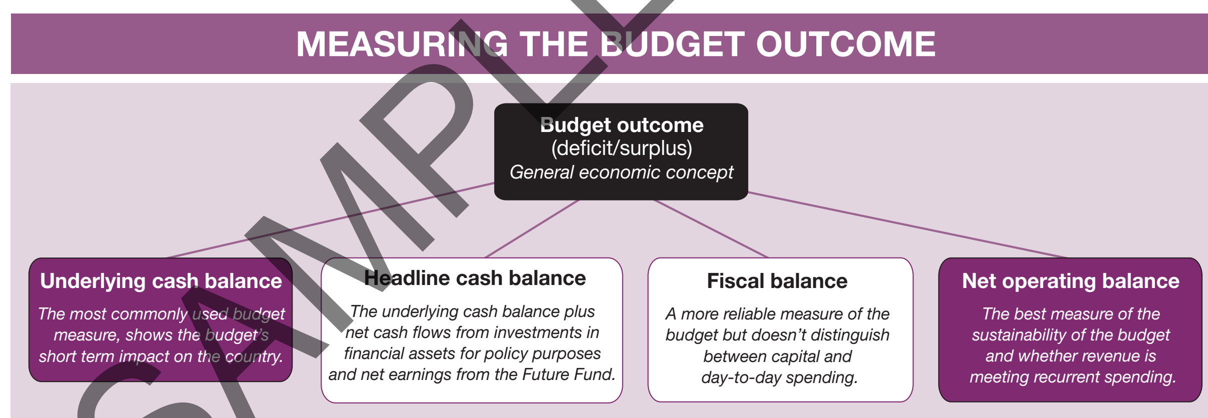
## 14.2 Budget outcomes

Besides the individual instruments of spending and revenue collection, the overall outcome of the Budget – known as the **budget outcome** – is itself an important feature of fiscal policy. The budget outcome gives an indication of the overall impact of fiscal policy on the economy.

There are three possible budget outcomes: a surplus, a deficit, or a balanced budget.

- **Budget surplus** – A positive balance that occurs when the Commonwealth Government anticipates that total government revenue (T) will exceed total expenditure (G) – that is, T > G.
- **Budget deficit** – A negative balance that occurs when total government expenditure exceeds total revenue – that is, G > T.
- **Balanced budget** – A zero balance that occurs when total government expenditure is equal to total revenue – that is, G = T.

The Government's main fiscal policy aim is to achieve budget surpluses, on average, over the course of the economic cycle. The Government's progress towards that goal is reflected in the four-year projections for budget outcomes that are provided in the Budget and other fiscal documents. In addition, since 2013–14 the Treasury has published a 10-year medium-term budget projection.




The Commonwealth Government's Budget includes four main measures of the budget outcome, which are the result of different accounting methods:

- The **underlying cash balance** (cash deficit or cash surplus) is the Government's preferred measure of the budget outcome because it gives an indication of the short- to medium-term impact of fiscal policy on the level of economic activity and the budget's call on cash resources from other sectors of the economy. It is calculated using the cash accounting method (which records revenues and expenditures when the money is collected or spent). However, it does not distinguish between the type of spending (for capital or recurrent purposes) and does not reflect international standards of accrual accounting. In figure 14.1, the underlying cash balance may vary from the difference between receipt and payments because net Future Fund earnings are removed until the Australian Government's superannuation liability is expected to be met.

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| Year | Receipts $bn | Payments $bn | Underlying cash balance | | Fiscal balance | | Net operating balance | |
|---|---|---|---|---|---|---|---|---|
| | | | $bn | % GDP | $bn | % GDP | $bn | % GDP |
| 1989–90 | 98.6 | 92.7 | 5.9 | 1.5 | n.a. | n.a. | n.a. | n.a. |
| 1994–95 | 113.5 | 127.6 | –14.2 | –2.9 | n.a. | n.a. | n.a. | n.a. |
| 1999–00 | 166.2 | 153.2 | 13.0 | 2.0 | 11.7 | 1.8 | 11.6 | 1.7 |
| 2004–05 | 236.0 | 222.4 | 13.6 | 1.5 | 12.2 | 1.3 | 13.3 | 1.4 |
| 2009–10 | 284.7 | 336.9 | –54.5 | –4.2 | –53.9 | –4.1 | –47.4 | –3.7 |
| 2014–15 | 378.3 | 412.1 | –37.9 | –2.3 | –40.8 | –2.5 | –38.1 | –2.3 |
| 2015–16 | 386.9 | 423.3 | –39.6 | –2.4 | –37.5 | –2.3 | –33.6 | –2.0 |
| 2016–17 | 409.9 | 439.4 | –33.2 | –1.9 | –35.0 | –2.0 | –32.1 | –1.8 |
| 2017–18 | 446.9 | 452.7 | –10.1 | –0.6 | –6.5 | –0.4 | –5.2 | –0.3 |
| 2018–19 | 485.3 | 478.1 | –0.7 | 0 | 1.4 | 0.1 | 7.5 | 0.4 |
| 2019–20 | 469.4 | 549.6 | –85.3 | –4.3 | –95.8 | –4.8 | –91.8 | –4.6 |
| 2020–21 | 519.9 | 654.1 | –134.2 | –6.5 | –136.1 | –6.6 | –128.9 | –6.2 |
| 2021–22 | 584.4 | 616.3 | –32.0 | –1.4 | –35.1 | –1.5 | –26.6 | –1.2 |
| 2022–23* | 635.6 | 631.4 | 4.2 | 0.2 | –1.5 | –0.1 | 9.0 | 0.4 |
| 2023–24* | 668.1 | 682.1 | –13.9 | –0.5 | –14.1 | –0.5 | –3.7 | –0.1 |
| 2024–25* | 671.2 | 706.3 | –35.1 | –1.3 | –45.3 | –1.7 | –38.0 | –1.4 |
| 2025–26* | 700.9 | 737.5 | –36.6 | –1.3 | –35.0 | –1.3 | –29.6 | –1.1 |
| 2026–27* | 735.1 | 763.6 | –28.5 | –1.0 | –32.8 | –1.1 | –23.5 | –0.8 |

Source: 2023–24 Budget Paper 1, Statement 11, Tables 1 and 6; *Estimate

**Figure 14.1 –** Recent Commonwealth Budget outcomes

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- The **headline cash balance** reflects the underlying cash balance plus the government's purchase or sale of assets. It is often billions of dollars higher or lower than the underlying cash balance, either because government assets have been sold or because new assets have been acquired. For example, the $6 billion privatisaion of Medibank in 2014 had a positive impact on the headline cash balance, but because such transactions are one-off (so could not be counted on to cover expenses in future years) they are not included in the underlying cash balance. Asset sales reduce the government's borrowing requirement to finance the deficit, but they also mean the government forgoes any dividends it might earn from the asset.
- The **fiscal balance** (fiscal deficit or fiscal surplus) calculates revenue minus expenses less net capital investment, based on accrual accounting. Accrual accounting measures expenditures and revenues when they are incurred or earned, rather than when a cash transaction actually occurs. For example, if the government's superannuation obligations to public servants increased by $5 billion in one year, this would increase a fiscal deficit by $5 billion for that year, even if the money is not paid out until years later. This is regarded as more accurate than cash accounting. However, the fiscal balance does not distinguish between spending for capital or recurrent purposes.
- The **net operating balance** (operating deficit or operating surplus) is regarded as the best measure of the sustainability of the budget because it shows whether a government is meeting its recurrent (day-to-day) obligations from existing revenue. The net operating balance distinguishes between spending for capital or recurrent purposes, and it removes spending on capital from the balance (that is, resulting in a smaller deficit or increased surplus), although it includes the cost of depreciation (the run-down in the value of existing assets). The rationale for separating the two types of expenses is that capital spending is different from other spending because it adds to productive capacity and to the government's assets. Like the fiscal balance, the net operating balance is based on accrual rather than cash accounting.

## reviewquestions

1. Explain the difference between a budget surplus and a budget deficit.
2. What is the difference between an underlying cash surplus and a net operating surplus?
3. Identify TWO key trends in recent budget outcomes and discuss the relationship between these trends and economic conditions.

# 14.3 Changes in budget outcomes

Each year, the levels of government spending and revenue collection, and thus the budget outcome, change. This reflects the impact of two key factors: changing economic conditions (known as cyclical or non-discretionary changes) and changes in government policy (known as structural or discretionary factors).

- **Discretionary changes in fiscal policy**. Discretionary changes involve deliberate changes to fiscal policy, such as reduced spending or changing taxation rates. If the government deliberately increased expenditure in order to stimulate demand, this would be an example of discretionary fiscal policy. Discretionary changes influence the **structural** component of the budget outcome.
- **Non-discretionary changes in fiscal policy**. The final budget outcome can be influenced by factors other than planned (discretionary) changes to government revenue and expenditure. These non-discretionary changes are caused by **changes in the level of economic activity.** When an economy is in recession, the budget deficit will increase, whereas during a period of strong economic growth the deficit will contract or the budget will shift into surplus. Non-discretionary changes influence the **cyclical** component of the budget outcome.

Budgetary changes that are influenced by the level of economic growth are also known as **automatic stabilisers**. Automatic stabilisers can be defined as those changes in the level of government revenue and expenditure that occur as a result of changes in the level of economic activity. They are referred to as "automatic" because they are built into the Budget, and they are activated by a change in the level of economic activity, **not by a deliberate change in government policy** relating to either revenue or expenditure.

**Automatic stabilisers** are policy instruments in the government's budget that counterbalance economic activity. In a boom period, they decrease economic activity, and, in a recession, they increase economic activity. The most common examples are transfer payments and a progressive tax system.

There are two main automatic stabilisers:

- **Unemployment benefits**. When the economy moves into recession, the level of economic activity falls, causing a rise in unemployment. An increase in unemployment leads to greater government expenditure on unemployment benefits. Thus, a decline in the level of economic activity automatically leads to an increase in government expenditure. On the other hand, an increase in the level of economic activity would have the opposite effect – causing a decrease in unemployment and less government expenditure on unemployment benefits.
- The **progressive income tax system.** Progressive income tax means that people on higher incomes pay proportionately more tax than those on lower incomes. During an economic boom, employment opportunities are increasing and incomes are rising. Rising incomes move workers into higher income tax brackets, and previously unemployed persons start paying income tax. Both situations lead to an increase in government taxation revenue. On the other hand, a decrease in the level of economic activity would lead to a decrease in taxation revenue.

**Counter-cyclical** policies are economic policies designed to smooth fluctuations in the business cycle. Macroeconomic policies such as fiscal policy and monetary policy are usually used as counter-cyclical policies.

Automatic stabilisers are built into the Budget with a **counter-cyclical role**. When economic growth is high, demand is automatically slowed through higher tax revenues and reduced government expenditure. On the other hand, when the economy moves into recession, it is given a boost by increased government expenditure through unemployment benefits.

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Nevertheless, it is important to realise that automatic stabilisers, on their own, are rarely strong enough to counter the effects of the economic cycle. Automatic stabilisers are not powerful enough by themselves to bring an economy out of a severe recession, or to curb an economic boom – they merely reduce the severity of the problem. Governments still rely upon discretionary policy measures to smooth the economic cycle as the Morrison Government did with the unprecedented measures to support economic activity in 2020, following the onset of the COVID-19 pandemic.

## Impact on economic activity

The most significant short-term impact of fiscal policy is how it affects economic activity. The **budget stance** (not to be confused with the budget outcome) refers to the impact of fiscal policy on economic growth and can be described as expansionary, contractionary or neutral:

- An **expansionary** stance is one in which the government is planning to increase the level of economic activity in an economy. This can occur through either a reduction in taxation revenue and/or an increase in government expenditure, creating either a smaller surplus, or a larger deficit than in the previous year. Expansionary fiscal policy leads to a multiplied increase in consumption and investment and stimulates aggregate demand, which will increase the level of economic activity.
- A **contractionary** stance is one in which the government is planning to decrease the level of economic activity in an economy. This can occur through either an increase in taxation revenue and/or a decrease in government expenditure, creating either a smaller deficit or a bigger surplus than in the previous year. Contractionary fiscal policy leads to a multiplied decrease in consumption and investment, dampening aggregate demand, which will decrease economic activity.
- A **neutral** fiscal policy stance occurs when the government plans to maintain the gap between revenue and spending at around the same level as the previous year. A neutral fiscal policy should have no effect on the overall level of economic activity.

## Impact on resource use

Fiscal policy changes can influence the allocation of resources in the economy directly or indirectly. Fiscal policy may directly affect resource use through government spending in a particular area of the economy, such as transport infrastructure (for example, the Western Sydney Airport construction) to help boost tourism growth. The indirect influence of fiscal policy covers tax and spending decisions that make it more or less attractive for resources to be used in a particular way – for example, removing taxes from ethanol production might encourage farmers to use more of their wheat, sugar and other crops to produce ethanol.

Governments are more likely to use direct measures to provide goods or services if they expect that markets will not provide the resources quickly enough without government intervention. For example, in an emergency situation such as a natural disaster or a pandemic, governments will usually step in and direct relief operations so that emergency resources are made available to the people most directly affected. Similarly, the government might pay directly to provide **public goods**, because it is unlikely that the private sector will produce such goods, and it is difficult to prevent anyone else from enjoying the benefit of those goods. Examples of public goods include lighthouses, street lighting, national defence and environmental protection agencies that enforce clean air standards.

**A public good** is an item that private firms are unwilling to provide as they are not able to restrict usage and benefits to those willing to pay for the good. Because of this, governments generally provide these goods.

Governments use specific taxing and spending policies that lead to changes in resource use that meet the government's objectives. For example, if the government wants to discourage the consumption of products without banning them, it might apply high tax rates, as it does with tobacco products (which generate the negative externality of increased health care costs through tobacco-related diseases). This helps to discourage tobacco consumption, which in the longer term may reduce the costs to the health care system.

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## Impact on income distribution

From year to year, changes in fiscal policy play the most important role of any government policy in influencing the distribution of income in the economy. Australia has a **progressive income tax system** designed to create a more equal distribution of income. People on higher incomes pay higher rates of income tax, allowing the government to use this money for transfer payments, community services and other types of social expenditure, which in particular assist people on lower incomes.

Changes to taxation arrangements can affect income distribution significantly. For example, a reduction in tax rates at the upper end of the income scale would make the tax system less progressive and may create a less equal distribution of income. Likewise, introducing tax concessions (that is, exemptions from tax for certain types of income such as earnings from superannuation) might affect the distribution of income without actually changing the tax rates. Similarly, if the government were to increase the rate of the Goods and Services Tax (a regressive tax), this would make the tax system less progressive and would result in lower-income earners paying a relatively higher proportion of their incomes in tax, increasing income inequality.

Budgetary changes involving government spending can also influence income distribution significantly. Increases in spending on community services such as health and aged care and labour market programs, or increases in welfare payments such as the age pension, will tend to reduce income inequality because they have a greater proportional benefit for low-income earners. On the other hand, Government spending cuts often increase income inequality because low-income earners tend to be more reliant on income support payments and government services than higher-income earners.

## Impact on savings and external balance

A long-term relationship exists between the budget outcome and the size of the current account deficit and foreign debt. There has been debate over the extent of this relationship for many years (see also chapter 10.5). Over the long term, a budget deficit decreases national savings because governments finance budget deficits by borrowing from private sector savings. A budget deficit (or more accurately, an overall public sector deficit) is a form of **negative savings**, or **dissavings**, that will reduce the level of national savings, which is composed of public savings plus private savings.

**Appendix B:** Advanced Economic Analysis at the back of this textbook looks at the relationship between the budget and the current account in more detail.

With a depleted national savings pool, the competition for a limited amount of savings to finance domestic consumption and investment will make it more difficult to access funds and place upward pressure on interest rates, making private sector investment more expensive. This is known as the **crowding out effect**. In a closed economy, this will lead to a decrease in private investment. However, in an open economy such as Australia, the crowding out effect is less pronounced as private sector borrowers may simply turn to overseas sources of funds to finance domestic investment and consumption. This will show up as an inflow on the capital and financial account and will increase the size of Australia's foreign debt. Alternatively, if the Government borrows from overseas, the inflow of funds will directly lead to an increase in Australia's foreign liabilities. This will raise the net primary income deficit as the higher level of foreign liabilities is serviced with higher interest repayments. Thus when the Government consistently runs large fiscal deficits over several years, the current account deficit will tend to be higher. However, there is very little evidence of any short-term relationship between budget deficits and the current account balance.

Australia's history of current account deficits reflects imbalances between private savings and private investment, rather than public sector borrowing. Nevertheless, one of the reasons for the objective of sustaining fiscal balance is to ensure that fiscal policy is not contributing to higher current account deficits in the longer term.

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## reviewquestions

1 Explain the role of cyclical and structural factors in influencing the budget outcome from year to year.

2 If the government wished to slow the pace of economic activity, explain what changes it would make to revenue and expenditure and the impact on the size of: a) a budget deficit b) a budget surplus.

3 Outline how fiscal policy might affect the distribution of income.

# 14.4 Methods of financing a deficit

In this section, we look at where and how the government obtains the extra money it needs when it budgets to spend more money than it receives, as well as what the government does with surplus funds when revenue exceeds expenditure.

When the government budgets for a deficit, it is planning to spend more than it receives in revenue over the current financial year. In short, this deficit is financed through **borrowing** from the domestic **private sector**, from **overseas investors** or **from the Reserve Bank** (by printing money, known as monetary financing). Alternatively, the government can also sell government assets. In recent times, when it has run a deficit, the Australian Government has relied almost exclusively on borrowing from the domestic private sector.

## Borrowing from the private sector

The main form of deficit financing is through borrowing from the private sector by selling Treasury Bonds domestically under a tender system. Under this system, the government sets the value of bonds to be sold (determined by the size of the deficit to be financed), and the prospective purchasers tender to buy a certain quantity at a particular rate of interest. The government then accepts the tenders, starting with those offering to buy at the lowest rate of interest, through to the highest, until all bonds are sold. The advantages of this system are twofold: the government can always be certain that it will fully finance its deficit, and the market will set the interest rate on these newly issued bonds.

However, it is also worth considering the effect of a deficit financed by domestic borrowing from the private sector on private sector spending, and in particular on private investment. The **crowding out effect** describes how a budget deficit will soak up funds in Australia's domestic savings pool, putting upward pressure on interest rates and leading to a reduction in private sector spending and investment (as discussed in the previous section). The private sector is "crowded out" of the domestic market by government borrowing, since lenders will prefer to lend money to the government. Under these circumstances, the private sector would have less access to domestic savings and may be forced to borrow overseas instead.

**Crowding out effect** occurs where government spending is financed through borrowing from the private sector, which puts upward pressure on interest rates and "crowds out" private sector investors who cannot borrow at the higher rates of interest.

The strength of the crowding out effect depends on economic conditions. If the government increases the fiscal deficit when the economy is in recession, it is less likely to crowd out the private sector, since investment spending would be low at this time. But if the government continued to run a deficit during periods of strong economic growth, when substantial private sector activity is already occurring, it would be more likely to lead to a significant crowding out effect. However, in an era of globalised financial markets, the crowding out effect is now much weaker since many of the financial institutions that buy bonds on domestic financial markets are from overseas. Overseas investors are attracted by Australia's low risk profile (reflected in the Australian Government's AAA credit rating) and the interest rate differential between Australia and other advanced economies. The estimated proportion of Australian government securities held by overseas investors fell

**Appendix B:** Advanced Economic Analysis at the back of this textbook looks at the theory of "crowding out" in more detail.

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from 76 per cent in 2012 to around 45 per cent in 2022, as Australia's interest rates compared to other countries made Australia's securities less attractive to overseas investors.

## Other methods of financing a deficit

While Australian governments have relied on financing deficits mainly through borrowing from the private sector, other methods are also available. These include borrowing from overseas, borrowing from the Reserve Bank and selling assets.

### Borrowing from overseas

Governments may borrow from overseas financial markets in order to minimise the crowding out effect, while still stimulating growth. In an era of global financial markets, it is less likely to be necessary to raise funds on overseas markets since old distinctions between domestic and overseas borrowing are now less relevant, as there are now many overseas institutions that participate in Australia's domestic financial markets. However, if the Budget was in deficit, the Government could, at any time, borrow directly on overseas markets and in overseas currencies should this become a less expensive option than domestic borrowing. When the Government borrows from overseas it directly adds to Australia's foreign debt, with interest repayments recorded as debits on the net primary income account of the balance of payments.

### Borrowing from the Reserve Bank (monetary financing)

The Government may simply borrow from the Reserve Bank to finance the deficit – this is sometimes referred to as "monetary financing" or "monetising the deficit". In effect, this amounts to the Government printing money in order to finance its expenditures. Since 1982, with the deregulation of the financial sector, the Government has not engaged in this kind of deficit financing. The Government has avoided monetary financing to ensure that it does not increase the money supply and add to inflation. This also means that there is no longer any direct connection between the implementation of monetary policy and fiscal policy (that is, they now operate independently of one another). However, as we will discuss in chapter 18, the policy settings of fiscal and monetary policy are indirectly related.

### Selling assets

An alternative to funding a deficit by borrowing is to sell government assets. Selling assets, such as Commonwealth land or the Commonwealth's share in businesses such as Medibank Private or Australia Post, does not reduce the level of such underlying cash deficit or the net operating deficit because these are adjusted to reflect one-off transactions like asset sales. However, in cash terms, from year to year, a government can create a headline budget surplus by selling assets. For example, if the Government raises $10 billion through asset sales, it simply means that it needs to issue $10 billion less in Treasury Bonds to finance its deficit. However, the demand for funds from Australia's pool of domestic savings remains essentially the same. This is because the buyers of the government asset will either reduce their savings by $10 billion, or borrow $10 billion, instead of the Government borrowing that money. The overall effect on the pool of domestic savings is the same, but the financing burden is simply shifted from the public sector to the private sector. Also, while reducing government borrowing reduces interest payments in the future, by selling assets, the government also forgoes any dividends it may have earned on the assets.

## Using budget surpluses

The alternative outcome to a deficit is a surplus. When the Government budgets for a surplus, it is planning to receive more revenue than it spends in the current financial year. The Government can use the surplus in three ways:

- depositing it with the Reserve Bank
- using it to pay off public sector debt
- placing the money in a specially established, government-owned investment fund.

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For several years during the late 1990s and early 2000s, the Government used surplus funds to pay off public sector debt. This reduces the size of public debt and frees up funds on financial markets for other purposes. For example, the increase in funds available for private sector investment may lead to economic activity that offsets the contractionary effect of the fiscal surplus.

During that period of budget surpluses, the Government established the Future Fund as a dedicated investment fund to store surpluses to meet the future cost of the Government's superannuation liabilities. Its assets were valued at $251 billion in 2023.

## Public sector borrowing and debt

Although changes in the budget outcome provide an important measure of the underlying stance of fiscal policy, they do not represent the full impact of the public sector on the economy. To get the full picture relating to the public sector's revenue raising and expenditure activities, we must also consider the activities of the rest of the public sector in Australia – the state and local levels of government, as well as public trading enterprises (also known as government business enterprises) such as Australia Post, Sydney Water and Sydney Trains.

The overall impact of the public sector on the economy is reflected in the **public sector cash outcome**. The deficit or surplus shows the borrowing needs or surplus funds from all levels of government, as well as government authorities and public trading enterprises. It gives the most comprehensive indication of the current impact of the public sector on the Australian economy. Figure 14.2 shows the public sector net operating balance as a percentage of GDP. A negative outcome means that there is an overall public sector deficit.

| Year | Commonwealth cash balance (% GDP) | State cash balance | Consolidated cash balance^ |
|---|---|---|---|
| 2012–13 | –1.2 | –1.4 | –2.9 |
| 2013–14 | –3.0 | –0.6 | –4.2 |
| 2014–15 | –2.3 | –0.3 | –2.8 |
| 2015–16 | –2.6 | –0.4 | –3.1 |
| 2016–17 | –2.1 | –0.4 | –2.5 |
| 2017–18 | –0.8 | –0.8 | –1.7 |
| 2018–19 | –0.1 | –1.1 | –1.3 |
| 2019–20 | –4.5 | –2.5 | –7.7 |
| 2020–21 | –6.7 | –2.8 | –9.2 |
| 2021–22 | –1.6 | –2.3 | –4.4 |
| 2022–23* | –0.1 | –1.8 | –2.4 |
| 2023–24* | –0.8 | –2.0 | –3.3 |

Source: 2023–24 Budget Paper No. 3 Appendix C, Table C7 *Estimate
^For technical reasons Commonwealth and State do not add up

**Figure 14.2 –** Non-financial public sector cash balance

The public sector cash outcome was in surplus from the late 1990s until 2008–09. The reversal of the Commonwealth Government's Budget position from surpluses throughout the 2000s decade to a deficit in 2008–09 was the main cause of the public sector cash outcome moving into deficit. The net operating deficit shows that in most years, the public sector's revenue has not met its recurrent spending.

Over a period of time, running a public sector deficit results in an accumulation of **public sector debt**. Public sector debt consists of the accumulated debt of the government sector, which is owed both domestically and overseas. This includes debt accumulated by the Commonwealth Government, state and local governments and government-owned businesses. As figure 14.3 shows, public sector debt in Australia rose during three periods: after the early 1990s recession, after the global financial crisis in 2008 and after the COVID-19 pandemic in 2020.

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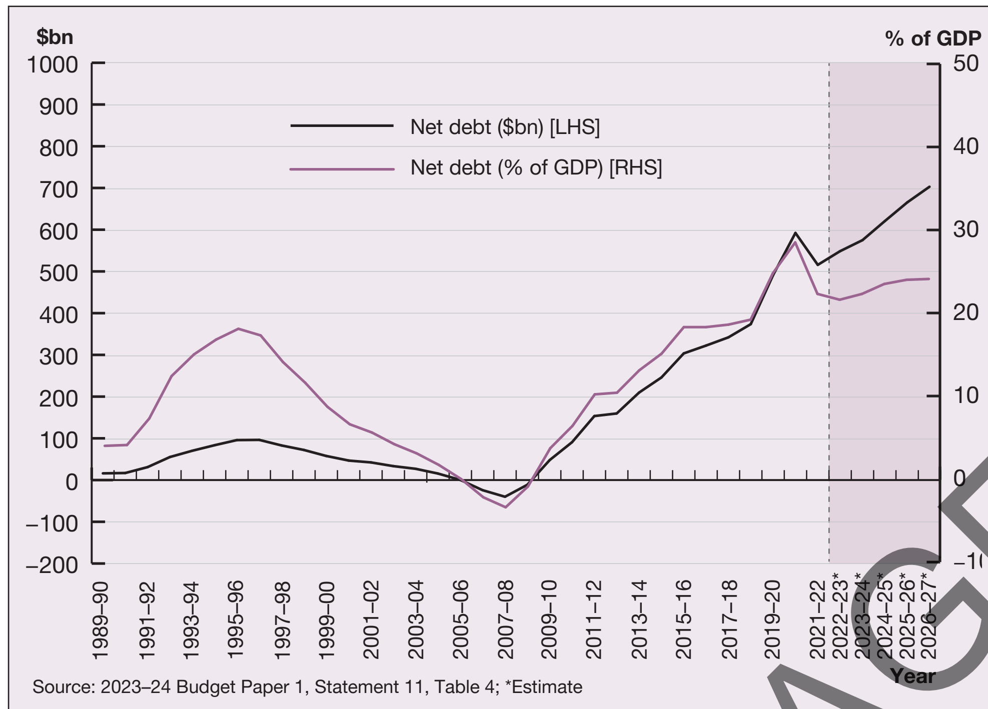


**Figure 14.3 –** Australia's net public sector debt

It is important to distinguish the public sector debt from the foreign debt, which is the amount owed by both the public and private sectors to overseas lenders. Australia's foreign debt is much higher than our public debt, and it mostly consists of private sector borrowings. When undertaking borrowings, governments generally source their borrowings from within Australia, although some of the participants in Australian financial markets are overseas-based institutions. By borrowing on domestic markets in Australian dollar securities, governments avoid being exposed to exchange rate movements that may increase their debt and interest servicing costs.

SAMPLE PAGES

## reviewquestions

1. Describe THREE ways in which a government might finance a budget deficit.
2. Explain the factors that could influence a government's decision about how to finance a budget deficit.
3. Outline which budget measure best reflects the overall impact of the public sector on the Australian economy.

## 14.5 The current stance of fiscal policy

For most years in the business cycle, fiscal policy plays a supporting role in the policy mix, with monetary policy used as the primary tool for macroeconomic management. So long as the economy is growing, governments tend to give priority to medium-term fiscal policy goals rather than using fiscal policy to influence the state of economic activity in the shorter term. However, when the economy experiences a major downturn, an event which tends to happen on average once per decade, governments use fiscal policy very actively to return the economy to growth. The most recent example of this active use of fiscal policy is in response to the COVID-19 pandemic and, before that, in response to the global financial crisis in 2008. In this section, we discuss the stance of fiscal policy since the pandemic struck in 2020 and identify key cyclical and structural influences on fiscal policy.

In the years prior to COVID-19, Australia's fiscal strategy was centred on a medium-term objective of returning the Budget to a surplus of 1 per cent of GDP. Fiscal policy played only a minor role in influencing the level of economic activity during this period, with a generally neutral or mildly contractionary policy stance. The Coalition Government had been elected in 2013 with a commitment to achieving budget surpluses, but this was not achieved until the 2018–19 Budget. At that time the Government also made a commitment not to allow tax receipts to rise above 23.9 per cent of GDP.

As figure 14.4 shows, during the 2010s the budget outcome gradually improved, but at a slower rate than had occurred during previous recoveries such as in the 1980s and the 1990s. The main reason for the slow progress was that despite a commitment to offset any new spending with other spending cuts, government expenditure continued to increase as a percentage of GDP during this period. At the same time, the recovery in tax receipts was slow, which explains why, after the global financial crisis had plunged the Budget into deficit in 2008, it was another 10 years until the Budget was again balanced.

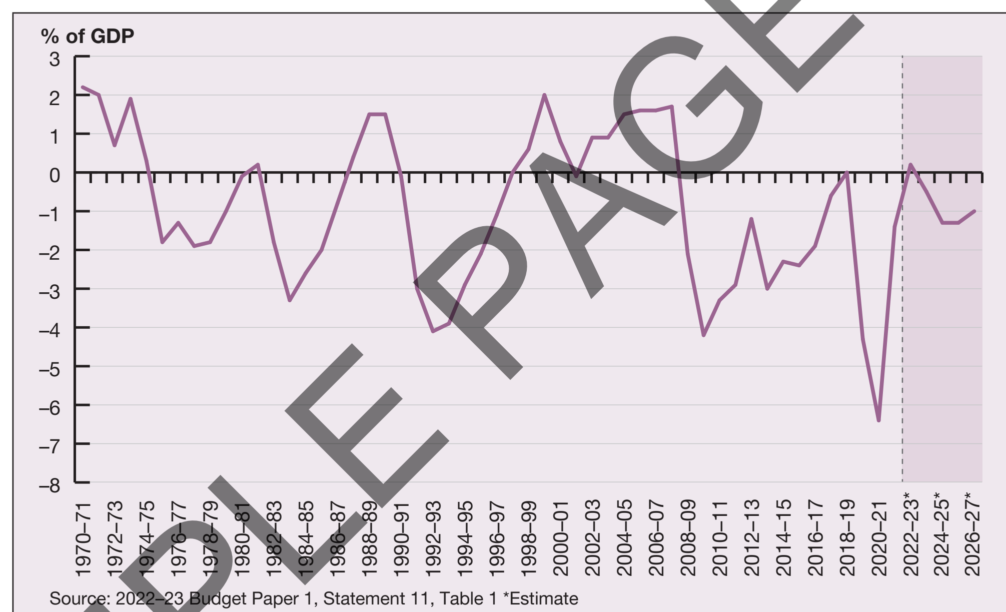


**Figure 14.4 –** Commonwealth underlying cash budget outcomes since 1970

The COVID-19 pandemic prompted a dramatic change in the fiscal strategy, with long-lasting effects. The Morrison Government used fiscal policy to cushion the economic effects of the pandemic and the lockdown that resulted in many businesses being forced to close temporarily. The Government introduced a comprehensive suite of policies, including JobKeeper – a program that at one stage in 2020 was subsidising the wages of around one-third of the workforce. The Government also implemented policies such as direct cash support payments to households and investment allowances for businesses.

This aggressive expansionary fiscal policy stance resulted in a significant deterioration in the budget outcome. After being in balance in 2018–19, the Budget recorded a deficit of $134 billion (6.4 per cent of GDP) in 2020–21. In just two years from 2018–19 to 2020–21, Australia's net public sector debt increased by nearly 50 per cent, from 19.2 per cent of GDP to 28.6 per cent of GDP. This was the result of a combination of discretionary policy measures (such as the introduction of the JobKeeper wage subsidy program) and the operation of automatic stabilisers, such as lower taxation receipts and increased welfare benefits. The combined impact of discretionary policy and automatic stabilisers was unprecedented.

As economic recovery led to a rapid fall in unemployment, from 2021–22 the fiscal stance became mildly contractionary, with a medium-term fiscal strategy of sustaining economic growth and stabilising and reducing debt, while also advancing longer-term government priorities.

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We can better understand the recent stance of fiscal policy by identifying the impact of cyclical and structural factors. The four key **cyclical factors** influencing the stance of fiscal policy in recent years are as follows:

- In the years prior to the COVID-19 pandemic, Australia saw a slower recovery in the budget deficit than usual, which showed that the economy was growing below its medium-term growth rate, and wages were consistently growing at below-forecast rates. This resulted in slower growth in tax receipts.
- The COVID-19 pandemic brought about the fastest cyclical downturn in the economy since the Great Depression of the 1930s. Record falls in business investment, household consumption, the labour market and trade activity triggered the automatic stabilisers in the Budget, through decreased taxation receipts (as incomes fell) and increased payments (as unemployment increased). In mid-2020, the Treasury estimated cyclical factors had resulted in a deterioration of the budget outcome of $105 billion over 2019–20 and 2020–21.
- Australia's terms of trade have been a positive cyclical influence on the budget outcome for several years. The Budget temporarily returned to surplus in 2022–23 due to revenues from the large surge in commodity prices (especially liquefied national gas) that followed Russia's invasion of Ukraine, but the trend towards high prices for major commodity exports (especially iron ore) that increased mining company profits and taxation revenues has been strong since 2016. Treasury estimated in the 2022–23 Budget that while it was assuming global prices for iron ore and coal would fall, a slower fall would result in Australia's nominal GDP being $123.7 billion larger, and the budget deficit being $17.7 billion lower in 2022–23.
- Australia's faster-than-expected economic recovery after COVID-19 has improved the outlook for the Budget. This reflects a combination of persistently high iron ore prices on company tax revenues, increased income tax receipts and lower unemployment benefit payments due to a rebound in the labour market, and lower than expected costs for emergency COVID-19 policies. The 2023–24 Budget saw a $67 billion increase in forecast tax receipts over the two years to 2023–24.

The three key **structural factors** (that is, discretionary government policy decisions) influencing the stance of fiscal policy in recent years are as follows:

- Prior to the onset of the COVID-19 pandemic, a structural reason for the slow progress in reducing the deficit was a trend increase in government spending. Federal government spending rose from 22.5 per cent of GDP in 2013–14 to 24.9 per cent of GDP in 2018–19. This reflected sustained, real increases in spending across several areas of government policy, such as for defence and the National Disability Insurance Scheme. Pressures to increase spending continue in a number of policy areas including unemployment benefits, education, health care and aged care.
- During the peak of the mining boom in the mid-2000s, governments implemented large reductions in personal income taxes that reduced revenue growth in the years after the global financial crisis. Earlier policy decisions to introduce new taxes on mining profits and carbon emissions were reversed or abandoned. The 2018–19 Budget also introduced a program of reductions in personal income tax phased in by 2024–25, which are expected to reduce revenue by more than $30 billion per year once fully implemented.
- Finally, a key longer-term structural influence on fiscal policy is the ageing of the population, which is contributing to slower growth in the revenue base (with more people in retirement), and increased spending pressures (on health and aged care). The Parliamentary Budget Office has estimated that by the end of the 2020s, aged care needs will add $36 billion per year to government spending, more than the current total annual expenditure on Medicare. The 2021–22 Budget set out a

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$17.7 billion increase in aged care funding over five years, and the 2023–24 Budget committed a further $11 billion to pay for higher wages for aged care workers, to help overcome staffing shortages.

"From energy bill relief to national defence, manufacturing to Medicare, investments in this Budget aim to make Australia more resilient and more secure in uncertain times. Fundamental to this is our responsible economic management and our efforts to put the Budget on a stronger foundation. This Budget, we've returned 82 per cent of the extra revenue windfall that's largely come from lower unemployment, stronger jobs and wages growth, and higher prices for key exports. We've now returned 87 per cent over this Budget and the last. We've also ... limited annual real spending growth to just 0.6 per cent over 5 years. Because our first 2 budgets made such a firm commitment to responsibility and restraint, we are now forecasting a small surplus in 2022–23 – which would be the first in 15 years ... because we are returning most of the welcome improvement in revenue to the budget, debt will be almost $300 billion lower by the end of the medium term, saving $83 billion in interest costs over the next 12 years."

*– Jim Chalmers, Treasurer of Australia, Budget Speech, 9 May 2023*

## BUDGET POLICY: LOOKING AHEAD TO 2063

One of Australia's instruments for long-term economic policy planning is the Intergenerational Report (IGR), which is updated approximately every five years. The IGR provides economic and fiscal projections for the next 40 years. The most recent report, released in 2023, provides projections for the Australian economy out to 2062–63.

The 2023 IGR projected that real GNI per person will grow at an annual rate of 1.0 per cent over the next 40 years, compared to 2.1 per cent in the preceding 40 years. So while living standards will be 50 per cent higher by 2063, annual growth will be half what it has been. One factor behind slower growth is that improvements in terms of trade lifted GNI significantly in the past 40 years but Treasury projects no similar contribution beyond that over the next 40. That leaves the Australian economy reliant on the "three ps" of productivity, participation and population for economic growth.

1 **Productivity**. The report assumes that productivity will continue to grow at 1.2 per cent annually, on average, similar to the level over the past 20 years (but notably well below the 1.5 per cent average of the past 30 years and the assumption in the previous IGR). Productivity is a key driver of income and economic growth.

2 **Participation**. Workforce participation is projected to decline from 66.8 per cent in 2023 to 63.8 per centby 2062–63. This is primarily driven by the ageing of the population, which is partially offset by a continued increase in women's participation in the workforce. The projected decline in participation is far milder than originally anticipated. When the first IGR was released in 2002 it projected workforce participation would sink below 60 per cent by 2023 and keep falling, which would have had significant consequences for the Commonwealth budget.

3 **Population**. Australia's population is projected to reach 40.5 million in 2062–63. The projected 1.1 per cent annual growth rate is below the historical average because of lower fertility rates and a migration level that while high, falls as a proportion of population over time.

The 2023 IGR projected the Budget to remain in deficit every year until 2062–63. As shown in figure 14.5, budget outcomes were expected to improve during the 2020s but then worsen from the 2030s as pressures on spending rise due to health and aged care, the National Disability Insurance Scheme (NDIS), defence and interest payments on Government debt, while the Government's ceiling on tax revenues prevents revenue from keeping up with expenditure growth.

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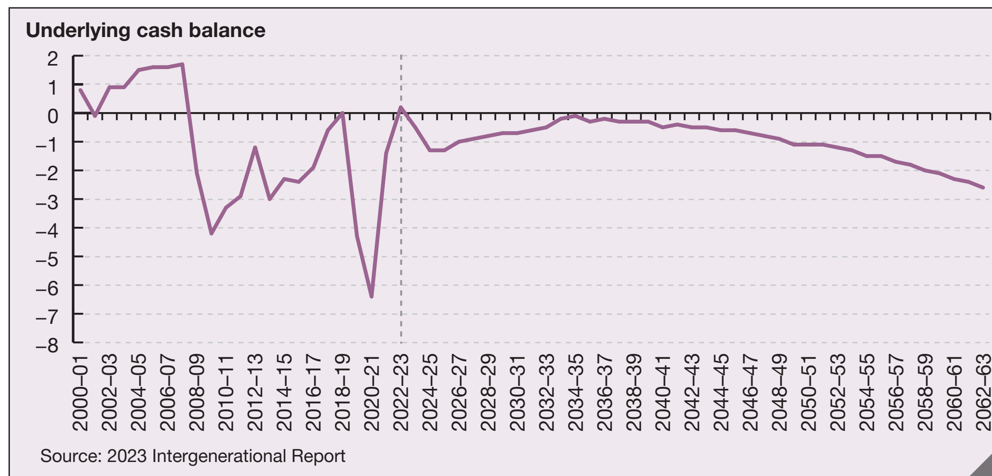


**Figure 14.5 –** The outlook for Australia's budget deficit through to 2063

## reviewquestions

1. Describe trends in Australia's budget outcome in recent years.
2. Evaluate the stance of fiscal policy in the current federal budget.
3. Explain the difficulties in reducing the budget deficit in recent years.

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# 14.6 The impact of recent fiscal policy

Recent years provide a case study of the impact of fiscal policy on the economy, with the COVID-19 pandemic prompting the largest-ever fiscal policy interventions in Australian economic history. In contrast, during the decade before the pandemic, fiscal policy was playing a relatively minor role in Australia's economic policy mix. While monetary policy played the critical shorter-term role of influencing the level of economic activity and keeping inflation within its target range, the goal of fiscal policy was to gradually return to surplus, and from time to time to achieve specific policy goals relating to the allocation of resources in the economy.

## Economic growth

Since the 1990s, fiscal policy has only played an active role in managing the economic cycle during major downturns – in the early 1990s, following the global financial crisis in 2008 and the COVID-19 pandemic in 2020. Outside of those periods, fiscal policy played a much smaller role in influencing the level of economic growth. The introduction of inflation targeting, independently implemented by the Reserve Bank of Australia, meant that monetary policy became the main macroeconomic policy instrument for influencing the level of economic growth. The 2023 Review into the RBA concluded that this macroeconomic strategy had been effective, and Australia should continue using monetary policy as the primary demand management tool.

The limited role for fiscal policy in the period before 2020 is reflected in the Budgets of the late 2010s. As the Budget gradually moved towards balance, the Morrison Government legislated long-term plans to reduce taxation rates for businesses and individuals, as part of its policy commitment to keep tax revenues below 23.9 per cent of GDP (in fact, tax revenues peaked at 23.4 per cent of GDP in 2018–19). Its objective in reducing tax rates was to provide more incentives for work, investment, job creation and economic growth by allowing individuals to retain more of their income, and companies to retain more of their profits.

The 2019–20 Budget announced three stages of reductions in personal income tax, with the first stage focused on a tax rebate for low- and middle-income earners between 2018–19 and 2020–21. The second stage, implemented from 2020–21 to 2023–24, raised the tax brackets, so that higher tax rates cut in at higher-income levels. The third stage, from 2024–25, involves abolishing the second-highest tax rate (of 37c in the dollar), benefiting middle- and upper-income earners. Fully implemented, the three stages of tax cuts contained in the 2019–20 Budget were expected to reduce revenue by $158 billion between 2019–20 and 2029–30, in addition to $144 billion in tax cuts announced in the 2018–19 Budget. During this period, the Government also reduced company tax rates for entities with a turnover below $50 million from 30 per cent to 25 per cent.

The role of fiscal policy changed dramatically from March 2020 as governments around the world focused on preventing the spread of the coronavirus. This approach is based on Keynesian economic theory, which dominated policymaking between the 1940s and 1970s, and which argued that an expansionary budget involving increased spending or tax cuts would accelerate economic growth. To offset the economic impact of lockdowns and disruptions to economic activity, the Australian Government announced a series of policies including cash payments to households, wage subsidies for businesses, investment allowances, industry support measures and increased expenditure on health and infrastructure. At the time, the Treasury estimated that the Government's budget policy measures (up to and including announcements in July 2020) would result in economic activity being 4.5 per cent higher in 2021–22 than it would otherwise have been.

A key feature of Australia's policy response to COVID-19 was to sustain business investment. The 2021–22 Budget introduced a policy of "immediate expensing", which allows business to make investments of any size and write off the full cost immediately, in contrast to normal practice, which only allows businesses to claim a tax reduction equal to the depreciation in the value of an asset (usually between five and ten years). The Budget also allowed businesses to claim a "loss carry-back" – allowing them to claim tax losses from the past. Businesses could undertake investment during 2021–22, claim the full deduction immediately, and then incur a tax loss. They would then become eligible to claim a refund against tax that they paid in past years, before the pandemic. The Government argued these measures would support investment and economic growth, and help reduce unemployment.

In the circumstances of 2020, there was a widespread consensus that the fiscal policy measures were necessary even though they resulted in the Budget moving from balance in 2018–19 to a deficit of 6.4 per cent in 2020–21, and net public sector debt rising from $374 billion or 19.2 per cent in 2018–19 to $592 billion or 28.5 per cent in 2020–21.

In the longer term, the effectiveness of fiscal policy in influencing economic growth may diminish if the accumulation of past budget deficits has created a high level of public debt. The Albanese Government's fiscal strategy is focused on reducing debt as a share of the economy. Unlike previous fiscal strategies, it does not explicitly target a return to surplus. Rather, it makes a commitment to improve the budget balance over time.

In evaluating the impact of fiscal policy on economic growth, it can also be important to take into account any impact that fiscal policy changes might have on monetary policy. Economists have differing views about the relationship between fiscal and monetary policies, but under an inflation-targeting regime, changes in fiscal policy can clearly affect monetary policy decisions – and possibly reduce any impact that fiscal policy might have. To the extent that changes in fiscal policy impact on inflationary pressures, fiscal policy can affect the Reserve Bank's monetary policy decisions. The 2023–24 Budget sought to manage the conflicting objectives of reducing inflationary pressures and supporting households struggling with cost-of-living pressures due to high inflation. The cost-of-living measures were designed to support households and reduce inflation, through subsidies on electricity bills and caps on wholesale energy costs. Treasury estimated

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headline inflation will be reduced by three-quarters of a percentage point in 2023–24 as a result of these measures, with the goal of reducing the need for further interest rate increases to address inflation.

## Unemployment and workforce participation

The short-term impact of fiscal policy on unemployment is closely related to the impact of fiscal policy on economic growth. In stimulating aggregate demand, expansionary fiscal policy can help to reduce unemployment or, during an economic downturn, reduce the rate at which cyclical unemployment increases. The priority of Australia's fiscal policy measures in response to the COVID-19 pandemic was to prevent a much larger surge in unemployment. The JobKeeper Payment played the central role in this strategy. Under this policy, the Australian Government was in effect paying the wages of workers at a time when many employers could not afford to pay them because of the suspension of normal economic activity. The Treasury estimated that this wage subsidy prevented a 5 percentage point rise in the unemployment rate. Without action to prevent those job losses in the short term, the Treasury argued that the recession would be much longer and more severe, given the time required for employers to recruit and for workers to find jobs in the months and years that followed.

With the unemployment rate rapidly falling after the pandemic, the role of fiscal policy in the labour market returned to its pre-pandemic focus. Measures were introduced to target priorities such as addressing skills shortages in specific trades or industry sectors, fostering career transitions and retraining older workers. The 2022–23 Budget included a $2.8 billion Australian Apprenticeships Incentive System, which aimed to streamline apprenticeships and create more places in priority areas, and a $550 million Skills and Training Boost, which provided a 20 per cent bonus tax deduction for small businesses to upskill their employees through external training providers.

Childcare policies have a major influence on how quickly parents are able to return to the workforce after a new birth. In 2022–23, the Albanese Government allocated $4.7 billion to increase the Child Care Subsidy to 90 per cent for eligible families. The plan's economic policy objective was increased workforce participation, by improving work incentives for second-income earners (most often women), by slowing down the rate at which rising family incomes result in lower childcare subsidies. The Government also announced $532 million to expand Paid Parental Leave to up to 26 weeks starting from 2026.

## Allocation of resources

Governments use expenditure and revenue measures to influence resource allocation in the economy less actively than in the past. Other than where there are market failures that need to be corrected, governments generally rely on market forces to achieve the most efficient allocation of resources. With the shift away from governments directly influencing resource allocation, the factors that shape market forces – such as changing consumer preferences, changing business practices, new technologies and the forces of globalisation – generally have the greatest influence on resource use.

Governments were once much more involved in the provision of services in Australia – they owned airlines, airports, banks, electricity utilities, insurance companies, phone companies, pharmaceutical businesses, printers, agricultural marketing businesses and gambling businesses. During the 1990s and the years that followed, most of these public trading enterprises were privatised and "user pays" systems have been introduced. Direct subsidies to industries have declined to less than $4 billion per year, and governments have even been willing to allow industries to shut down altogether, as the Abbott Government did with the closure of Australia's car manufacturing sector in 2013. Nevertheless, some areas of government expenditure still have a significant effect on resource allocation. The 2023–24 Budget set out an additional $4 billion of funding for Australia's transition to cleaner energy sources, bringing to $40 billion its total funding commitment to accelerate

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the growth of renewable energy industries. In addition, Australia is committed to spending tens of billions of dollars on building submarines in Australia as part of its commitment to the local defence industry and the AUKUS alliance.

Governments can also have a significant influence on resource allocation through their general policy settings, especially through regulations, tax concessions and exemptions. An example of regulation that influences resource use is the Renewable Energy Target that successfully required by 2020 that around 23 per cent of energy generation came from renewable sources (through a system of renewable energy certificates).

## National savings and the current account balance

Fiscal policy can influence an economy's level of national savings, either by increasing savings (through surpluses) or detracting from savings (through deficits). Rather than using the Budget directly to address Australia's large current account deficit, in recent decades the Government has pursued a goal of budget surpluses over the medium term so that the Government is not directly adding to Australia's savings imbalance. Over time, this should help contribute to improving Australia's external balance.

The extent to which a budget deficit leads to a current account deficit (a relationship sometimes known as the "twin deficits" hypothesis) has been a matter of economic debate in Australia since the 1980s. In reality, the current account is influenced by many factors, and the level of budget deficits is just one of many. As figure 14.6 shows, there is no direct linkage between Australia's budget outcome and the current account deficit. In some periods, such as the mid-2000s, the current account deficit may increase even when Australia is recording sustained budget surpluses. At other times, such as in recent years, the current account may move into surplus while the budget moves sharply into deficit. This reflects the fact that, although budget outcomes influence national savings, and national savings influences external balance, at any moment in time many other factors are also influencing those economic outcomes. Nevertheless, this does not mean that the level of public savings has no effect on the current account over the longer term. A higher level of public savings (and therefore national savings) is likely to result in a lower current account deficit than if the Government has a budget deficit, and vice versa – but the relationship is long-term not short-term, and influenced by many other factors.

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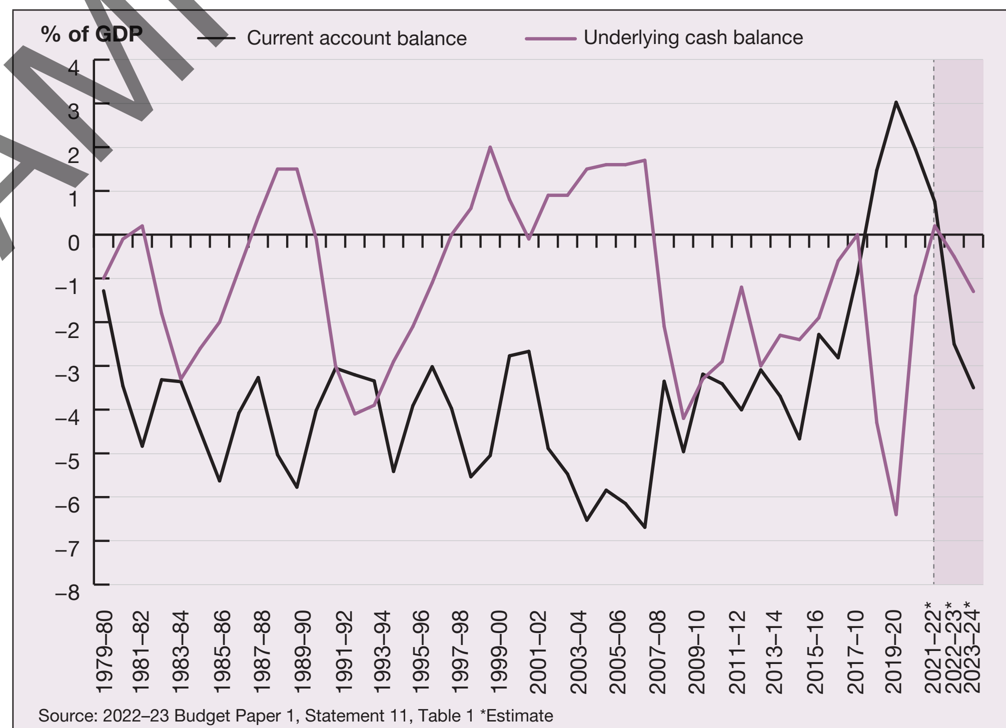


**Figure 14.6 –** The budget outcome and the current account deficit since 1979

## Distribution of income

Fiscal policy decisions have significant impacts on the distribution of income, and the distributional effects of policy changes are often a major feature of debates about budget policies. The Budget can impact income distribution through specific tax and revenue measures, as well as through its broader impact on economic conditions.

A key goal of the Australian Government's response to the COVID-19 pandemic was to prevent the large-scale job losses that could lead to a widening of inequality in the distribution of income. In addition to the JobKeeper Payment that subsidised the wages of around 3.5 million Australians (at a cost of $90 billion), the Government temporarily relaxed access to unemployment benefits, while also increasing payments through the Coronavirus Supplement of $550 per fortnight, at a cost of $16.8 billion. It also provided a direct cash support payment of $1500 to pensioners, income support recipients, carers and student payment recipients, costing $9.4 billion. These measures provided assistance to lower-income earners.

The 2023–24 Budget contained a range of measures to assist groups most affected by inflationary cost-of-living factors. These measures included $3 billion in subsidies for electricity bills for five million Australian households, a $20 per week increase in the JobSeeker payment and a 15 per cent increase in rent assistance payments.

In contrast to the positive effect of measures during the pandemic, the income tax reductions phased in from the late 2010s through to 2024–25 were widely criticised for making the tax system less progressive by reducing the number of tax thresholds from four to three. Other measures included a reduction in tax rates and a lifting of tax brackets. An analysis of the tax package by the Grattan Institute in 2019 concluded that it would make Australia's tax system less progressive than at any time since the 1950s. Its modelling showed that while someone in the middle of the income distribution would have an increase in their tax rate of 3.7 per cent by 2030 under the package, the average tax rate for the top 15 per cent of income earners would fall by 1 per cent. Overall, the share of income tax paid by middle-income earners will rise from 32 per cent in 2017–18 to 35 per cent by 2029–30. On a standard measure of progressivity of tax systems (comparing tax paid on incomes 0.5 versus 2.5 times average earnings), Australia would fall from 12th in the OECD in 2017–18 to 19th by 2024–25.

### reviewquestions

1. Outline the main impacts of fiscal policy in recent years.
2. Identify TWO ways in which the recent Budget might impact the level of economic growth.
3. With reference to recent economic examples in Australia, identify TWO ways in which a fiscal policy change might affect the distribution of income.

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# chapter summary

1. **Fiscal policy** involves the use of the Commonwealth Government's Budget to achieve the Government's objectives by influencing economic activity, resource allocation and income distribution.

2. The main tools of fiscal policy are **government spending**, **revenue collection** and the **budget outcome**. These are usually changed once each year in the Commonwealth Government Budget, which is usually released in May.

3. The budget outcome can be a surplus, deficit or balanced. The budget stance gives an indication of the overall impact of fiscal policy on the state of the economy and can be described as **expansionary**, **contractionary** or **neutral**.

4. The two main measures of the budget outcome are the **underlying cash outcome**, which is calculated through an accounting method known as cash accounting and which includes capital spending, and the **net operating balance**, which is calculated using a different accounting method as revenue minus expenses, with capital expenditure removed.

5. The **net operating balance** is the best indicator of the sustainability of the fiscal strategy because it shows the gap between recurrent expenses and revenue (that is, it distinguishes between capital spending and day-to-day spending). The **underlying cash outcome** is the best indicator of the short-term impact of fiscal policy on the level of economic activity because it shows actual cash revenue and spending in a year.

6. Spending, revenue and budget outcomes are affected by **discretionary** or **structural** factors, involving policy changes by the government, and **non-discretionary** or **cyclical** factors, which relate to the impact of changing economic conditions on the levels of spending and revenue collection.

7. Unemployment benefits and progressive income tax are known as **automatic stabilisers** because they are a built-in counter-cyclical component of the Budget.

8. A **budget deficit** is usually financed through borrowing from the private sector, which reduces national saving and may put upward pressure on interest rates. It can also be financed by borrowing from overseas or from the Reserve Bank (printing money), or by selling government assets.

9. Generally, fiscal policy plays a limited role in macroeconomic policy. Monetary policy is usually the primary tool to control short-term fluctuations in growth and inflation. However, during periods of economic crisis, fiscal policy can play an important role in supporting aggregate demand.

10. In contrast to its generally neutral or mildly contractionary stance during the 2010s, in 2020 the Government shifted fiscal policy to a very expansionary stance, helping to accelerate Australia's recovery from the COVID-19 pandemic. More recently, fiscal policy has been returning to a mildly contractionary stance.

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# chapter review

1. Explain what is meant by *fiscal policy*.
2. Distinguish between the possible budget outcomes of surplus, deficit and balance.
3. Describe the major instruments of fiscal policy.
4. Distinguish between the underlying cash balance and the net operating balance. Explain what each indicates about the budget stance.
5. Explain how automatic stabilisers play a counter-cyclical role in the budget.
6. Outline how fiscal policy impacts on the following:
   (a) economic growth
   (b) resource use
   (c) income distribution
7. Explain how the government can finance a budget deficit.
8. Distinguish between public debt and foreign debt.
9. Discuss the impact of recent changes in fiscal policy on the Australian economy.
10. Account for the trends in budget deficits during recent years.

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# 15 Monetary Policy


**15.1** Introduction

**15.2** The objectives of monetary policy

**15.3** The implementation of monetary policy

**15.4** The impact of changes in interest rates

**15.5** The stance of monetary policy in Australia


## 15.1 Introduction

**Monetary policy** refers to actions by the Reserve Bank of Australia (RBA), Australia's central bank, to influence the cost and availability of credit in the Australian economy. Monetary policy is a macroeconomic policy that, like fiscal policy, can smooth fluctuations in the business cycle and influence the level of economic activity, employment and prices. Monetary policy is generally the primary macroeconomic policy used for this purpose over the short to medium term in Australia and other advanced economies. This chapter outlines the objectives of monetary policy and how it is implemented to influence economic outcomes.

The formal objectives of monetary policy and the powers of the RBA are set out in federal legislation in the *Reserve Bank Act* (1959), along with the broader powers and responsibilities of the RBA. There is also a complementary agreement between the Commonwealth Government and the RBA Governor called the *Statement on the Conduct of Monetary Policy*. The agreement expresses a shared understanding of how the formal objectives can be met by the RBA and how monetary policy should be conducted in more detail. Within the scope set out by these documents, the RBA is authorised to make monetary policy decisions independent of the Federal Government.

One of the RBA's key roles is to hold and manage deposits owned by commercial banks in Australia that they use to settle transactions between each other. This gives the RBA the ability to influence the supply of money in the economy and therefore interest rates. The RBA sets a desired target for the **cash rate** (which is the interest rate on loans in the overnight money market), and uses **open market operations** (OMOs) to help achieve it. The cash rate influences other interest rates in the economy.

**Contractionary** monetary policy is when the RBA increases interest rates in the economy, which reduces the amount that households with mortgages have available for consumption and makes business investment more expensive. This lowers economic activity, reduces employment growth and reduces inflationary pressure. **Expansionary** monetary policy is when the RBA lowers interest rates, resulting in higher consumption and investment, economic activity, employment growth and inflation. Since the early 1990s, monetary policy has been guided by an inflation-targeting framework, which seeks to keep inflation between 2 and 3 per cent.

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## AN INDEPENDENT REVIEW OF THE RBA

In 2022, the Albanese Government initiated the first independent review of the RBA since inflation targeting was introduced in the early 1990s. The purpose of the review was to reassess the RBA's objectives and performance.

The review's 51 recommendations were released in March 2023. The Government agreed in principle with all of the recommendations, including:

- Clearly defining the objectives for monetary policy as a dual mandate to contribute to price stability and full employment, with an overarching purpose to promote economic prosperity
- Increased information sharing between the RBA and Treasury, through performing joint scenario analysis
- Reducing the number of Board meetings each year from 11 to 8 and increasing the time spent on monetary policy and strategy
- Creating two separate boards for the governance of the RBA and for the conduct of monetary policy
- Improving transparency through Board members speaking publicly about the Board's decisions
- Implementing 5-yearly reviews of the monetary policy frameworks and tools.

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# 15.2 The objectives of monetary policy

The objectives of monetary policy are laid out formally in the *Reserve Bank Act of 1959*, which states that in its implementation of monetary policy the RBA should aim for:

- The stability of Australia's currency – which now means maintaining low and stable inflation and preserving the purchasing power of the Australian dollar.
- The maintenance of full employment in Australia – which means sustaining a low level of unemployment.
- The promotion of the economic prosperity and welfare of the people of Australia – which primarily means maintaining a stable and sustainable economic and financial environment.

The 2023 review of the RBA recommended that the objectives should be clarified as a dual mandate for price stability and full employment only, with the promotion of economic prosperity not being a separate third objective but, instead, an overarching purpose for the RBA. This recommendation is intended to reduce the discretion of the RBA in its application of monetary policy and support it in focusing on two objectives. At times, it can be difficult for the RBA to achieve all three objectives simultaneously. Since the early 1990s, the RBA has generally prioritised the first objective: the maintenance of low and stable inflation via its inflation-targeting regime. Executing monetary policy in this manner can come at the expense of the RBA's employment objective. For instance, when inflation is high, the RBA will increase interest rates which can restrict economic activity and lead to a rise in unemployment.

## Inflation targeting

Since the 1990s, Australia has followed the example of several other countries, including Canada and New Zealand, where the central bank operates independently of the government to try to keep inflation within a predetermined target range (the target is normally jointly agreed upon by the central bank and the government). In doing so, the RBA prioritises maintaining low and stable inflation over all else. This reflects several important characteristics of monetary policy:

- Monetary policy is effective at fighting high levels of inflation.
- When assigned multiple goals, monetary policy often struggles to achieve them simultaneously. Listing one objective as the main one to achieve makes monetary policy more certain, consistent and predictable.
- When governments control monetary policy directly, their policy decisions can be distorted by political pressures, particularly at times of elections, when politicians

may want to keep interest rates low even if that might be suboptimal for the economy. Giving independence to a central bank in its conduct of monetary policy helps to reduce the risk of political factors distorting interest rate decisions.

- Inflation targeting has generally been successful at keeping inflation low and stable without central banks having to resort to high interest rates, which lower growth and increase unemployment. In other words, keeping inflation low and stable over the medium to long run helps the RBA achieve its other objectives as well. This largely explains why price stability is the primary objective for the RBA and other central banks. To sustain low and stable inflation, inflation targets need to entrench expectations in the economy that inflation will be low and stable over time. This is because expectations are a significant factor influencing the level of inflation.

The RBA's specific inflation target is to keep inflation between two and three per cent. It is important that the target is flexible and presented as a range. This reflects that inflation can be affected by shocks and events outside of the RBA's control, such as the COVID-19 pandemic and the war in Ukraine, and that the RBA must use its judgment to quickly return inflation to near the midpoint of its target. The target was previously expressed as between "two and three per cent, on average, over time", but the review of the RBA recommended removing the qualifying words "on average, over time" because they weakened the RBA's accountability for inflation outcomes.

Price stability is desirable because it allows households and businesses to prosper, and improves overall welfare in the economy. This prosperity is the overarching goal of monetary policy in Australia, so it is pursued by the RBA even if it means short-term inflation numbers are inconsistent with the target.

Successive governments have supported the RBA's flexible inflation target consistently since it was first introduced. Governments since the 1990s have broadly endorsed this approach in written agreements between the Governor of the RBA and the Australian Government (these agreements can be thought of as agreements on how the RBA should go about pursuing the legislative objectives described previously). The most recent agreement is the 2023 Statement on the Conduct of Monetary Policy following the review of the RBA. The 2023 Statement reaffirms the Government's commitment to the independence of the RBA and its support for the inflation-targeting framework.

The inflation-targeting regime clearly places the goal of price stability at the centre of monetary policy. However, reducing unemployment and promoting prosperity are still important goals of monetary policy. The flexibility of the regime supports the RBA in its exercise of monetary policy.

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"Just because our inflation objective has been in focus recently, it does not mean that the other part of our mandate – maintaining full employment – has become any less important. Full employment is, and has always been, one of our two main objectives …
We think of full employment as the point at which there is a balance between demand and supply in the labour market (and in the markets for goods and services) with inflation at the inflation target; this is the level of employment that is sustainable with our price stability mandate in the longer term."

*– Michele Bullock, (then) RBA Deputy Governor,*
*Achieving Full Employment (speech), 20 June 2023*

The RBA's inflation-targeting regime has been in place for about three decades. The review of the RBA recognised that this regime "remains the best operational framework for monetary policy". Since the regime was introduced, inflation has averaged around 2.6 per cent. Expansionary monetary policy also supported economic activity during the Asian financial crisis in the late 1990s, the global financial crisis in 2007–08 and the COVID-19 pandemic.

Despite success in maintaining economic stability and low inflation during the inflation-targeting era, monetary policy in Australia has attracted criticism in recent years. In the years leading up to the pandemic, critics argued that the RBA's monetary policy stance was not expansionary enough, especially when inflation was below the target band. When inflation increased sharply in 2022, critics said the RBA's response to COVID-19 was too expansionary. These views were part of the impetus for an independent review of the RBA which was completed in 2023.

## APPOINTING A NEW GOVERNOR OF THE RBA

Michele Bullock's term as Governor of the Reserve Bank began in September 2023, replacing Philip Lowe who had been Governor since 2016.

The Treasurer appoints the Governor of the Reserve Bank for a term of seven years, with the possibility of extending that term. As his predecessors (Glenn Stevens and Ian Macfarlane) had their appointments extended by three years each, there was speculation in 2023 as to whether the same would occur for Lowe.

The end of Philip Lowe's term was unusual because of the lack of support and confidence he faced as Governor steering the economy through the COVID-19 pandemic and its aftermath. Despite interest rates being raised by central banks all over the world following the pandemic, public sentiment turned against Lowe. "He did no worse than any other central bank, and some got it worse," noted Warwick McKibbin, a former member of the Reserve Bank Board. While the British Government defended the Bank of England Governor for raising interest rates, Lowe was exposed to public and political anger during the interest rate tightening cycle.

Much of this criticism stemmed from a statement that Governor Lowe had made in 2021 when the cash rate was at a historic low of 0.1 per cent, saying it was "very likely to remain at [that level] until at least 2024". People who borrowed funds based on that advice faced rising repayments and cost-of-living pressures as interest rates increased.

The purpose of the 2023 review of the RBA was to identify improvements to the RBA's operations, in the context of significant changes in the policymaking environment in recent decades. The review also aimed to assess external criticisms that the RBA's culture was too insular and hierarchical.

Part of the Government's rationale in appointing a new governor was to install someone new to drive institutional reform of the RBA through implementing the review's recommendations. While domestic and international candidates were considered, Bullock's appointment follows a trend since the mid-1990s of Deputy Governors succeeding Governors in the role.

SAMPLE PAGES

## reviewquestions

1. Outline the broad objectives of monetary policy.
2. Define *inflation targeting* and discuss why it is used in Australia.
3. Briefly explain how the following events would impact on the RBA's decision-making process when it influences interest rates:
   a) wage growth of 6 per cent
   b) a sustained fall in consumer spending
   c) a sudden fall in the value of the Australian dollar
   d) predictions of a sharp fall in inflation in 2024–25.

### MAIN ECONOMIC INDICATORS TAKEN INTO ACCOUNT BY THE RBA

- Inflation
- Expectations of future inflation
- Wages growth
- The unemployment rate
- Economic growth
- Interest rates
- The exchange rate
- Commodity prices
- Terms of trade
- Global economic conditions

## 15.3 The implementation of monetary policy

**Cash rate** is the interest rate paid on overnight loans in the short-term money market.

Whenever the RBA announces the cash rate, the Reserve Bank Governor releases a statement to explain the RBA's decision, and the minutes from the meeting are released two weeks later. These documents, along with a range of other useful information, are available on the RBA's website.

Using the RBA's statistics page, identify the most recent statistics for inflation, growth, unemployment and wages. Explain how these indicators justify the current level of interest rates in the Australian economy.

The **cash rate** is the main tool that the RBA uses to implement monetary policy. The cash rate is the interest rate in a financial market called the overnight money market – the market for very short-term loans between banks, where loans are literally made for overnight use in many cases. The cash rate influences many other interest rates in the economy (such as rates on mortgages and business loans), and the general level of interest rates influences inflation and the overall level of economic activity. The RBA can therefore achieve its economic objectives through its capacity to change the cash rate.

Until the end of 2023, the RBA Board met 11 times a year to set a target for the cash rate. In line with the recommendations of the RBA review, this was changed from 2024 onwards, with the establishment of a separate Monetary Policy Board meeting eight times per year (on the first Monday and Tuesday of relevant months), with its policy decision announced at the end of the meeting. The RBA is responsible for ensuring that the actual cash rate is consistent with the target announced by the board.

To fully understand monetary policy, it is important to understand more about what the cash rate is and the mechanics of how it is determined. The mechanics of the cash rate and the overnight money market can jointly involve three key elements: exchange settlement accounts, the policy interest rate corridor and domestic market operations.

### Exchange settlement accounts

Commercial banks need to hold a certain proportion of their funds with the Reserve Bank in exchange settlement accounts (ES accounts) to settle payments with other banks and the Reserve Bank. For example, when a customer of the Commonwealth Bank of Australia (CBA) uses a debit card to buy a good or service from a business that has a bank account at National Australia Bank (NAB), funds need to flow from CBA to NAB to complete the transaction. Many interbank payments like this need to happen every day. These payments are made by transferring funds between banks' ES accounts. At the end of every trading day, some banks may not have enough funds in their ES accounts to satisfy all of their interbank payment obligations for that day, while other banks may have a surplus of ES funds. These other banks can hold excess ES balances in accounts at the RBA as a way of storing value.

The overnight money market (also known as the short-term money market) is the market where banks that have a shortage of ES funds can borrow money from banks that have an excess of ES funds beyond what they need in their accounts. The market therefore enables banks to always settle their interbank payment obligations with each other. As with any other financial market, demand by borrowers and supply from lenders interact to set the market price (interest rate). But unlike other financial markets, the RBA can influence the overnight money market to ensure that the actual cash rate lines up with the target that the RBA board sets for it. The RBA does this using the policy rate corridor and open market operations.

### The policy rate corridor

The RBA does not directly set the actual cash rate at the target that it announces. But the RBA ensures that the actual cash rate can never stray far from the target because of how the RBA deals with the funds in commercial banks' ES accounts.

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Firstly, the RBA normally pays an interest rate to banks on funds held in ES accounts that is 0.25 percentage points below the cash rate target (for example, if the cash rate target is 1 per cent, the RBA's deposit rate is usually set to 0.75 per cent). This means that banks with excess ES balances are not given an incentive to lend funds to other banks if the actual cash rate is less than 0.25 percentage points below the target; these banks could earn greater returns by simply leaving their extra funds in their ES account and ignoring the overnight money market. The RBA's deposit rate therefore creates a *floor* or minimum value for the cash rate.

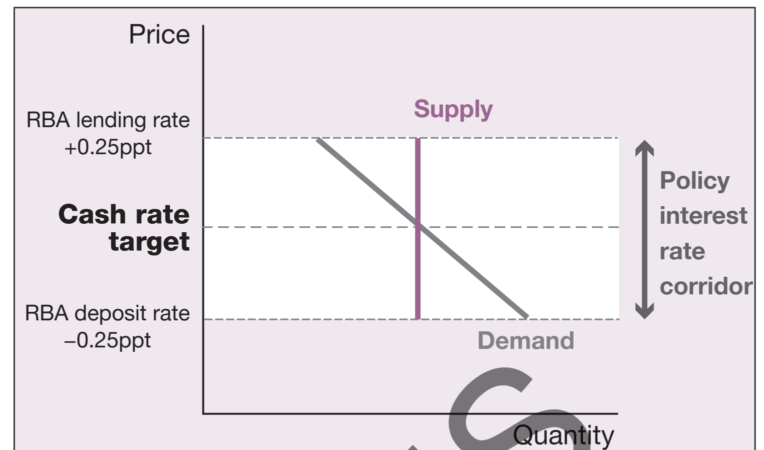


**Figure 15.1 –** The Australian cash market

Secondly, the RBA is always willing to lend ES balances directly to banks outside of the overnight market. The RBA always sets an interest rate on these loans equal to 0.25 percentage points above the cash rate target (for example, if the cash rate target is 1 per cent, the interest rate on these loans is set to 1.25 per cent). Banks that need to borrow ES balances are not incentivised to pay a rate higher than the RBA's lending rate in the overnight money market. If the cash rate were higher than the RBA's lending rate, banks would simply borrow ES funds directly from the RBA. The RBA's lending rate therefore creates a *ceiling* or maximum value for the cash rate.

The floor created by the RBA's deposit rate and the ceiling created by the RBA's lending rate together form the policy rate corridor for the cash rate. No banks, whether they have a surplus or a shortage of ES funds, have an incentive to complete transactions in the overnight money market outside of this corridor. The RBA's policy target for the cash rate is normally exactly in the middle of the corridor. This helps ensure that the actual cash rate always closely follows the RBA's target cash rate.

The policy rate corridor is responsible for implementing changes to the RBA's cash rate target. If the RBA were to decrease the target, the floor and ceiling of the corridor would shift downwards immediately, and banks would be incentivised to borrow and lend from each other within a new range that is consistent with the new cash rate target (see figure 15.2).

In reality, there is no mechanism that forces the actual cash rate to be exactly the same as the cash rate target (that is, in the middle of the band). However, there is a well-established convention that the actual cash rate should be the same as the target. Borrowers and lenders in the overnight money market generally follow this convention. Because of this, changes to the cash rate happen as soon as the RBA announces a change to its target – the RBA does not have to do anything besides make the announcement.

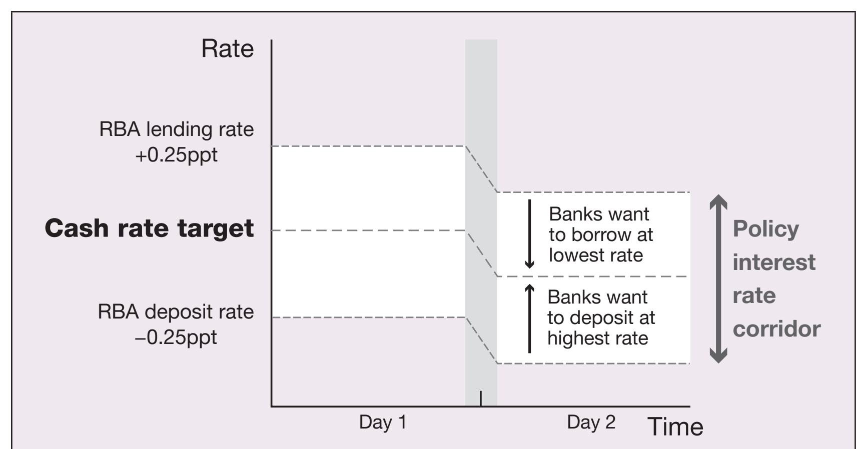


**Figure 15.2 –** Policy interest rate corridor

## Domestic market operations

Demand for ES balances by banks fluctuates on a daily basis. This is especially the case on days where there are large transactions or payments in the economy, such as when the Government pays social security benefits. The actual cash rate is the price at which this demand intersects with the supply of ES funds that are available. The RBA can manage the level of supply of ES funds so that it meets demand at a price closer to the RBA's cash

SAMPLE PAGES

rate target. This management of supply is what reinforces the convention mentioned above, so it is important for ensuring the actual cash rate stays in line with the target. Without the prospects of these interventions, the cash rate would bounce around inside the policy rate corridor whenever demand fluctuates.

**Domestic market operations** are actions by the Reserve Bank in the short-term money market to buy and sell second-hand Commonwealth Government Securities to influence the supply of exchange settlement balances in order to keep the actual cash rate at the policy target.

The RBA manages the supply of ES funds by conducting **domestic market operations** (DMO). DMO refers to the purchase and sale of financial securities by the RBA in exchange for ES balances. These purchases and sales affect the supply of ES funds because ES funds are used to complete these transactions. If the demand for ES funds increases, the RBA would need to increase the supply of ES funds to keep the cash rate stable, all else being equal. To do this, the RBA would **buy financial securities** held by banks, and pay for this by depositing funds in their exchange settlement accounts. This increases the supply of ES funds so that it meets the additional demand. If the RBA needed to decrease the supply of ES funds to keep the cash rate at target (because of a decrease in demand), the RBA would **sell financial securities** to banks, and withdraw funds that were sitting in their exchange settlement accounts. This would decrease the supply of ES funds down to the lower level of demand.

DMO usually involves the use of **repurchase agreements** (also called repos), where the "seller" of a bond or other financial security effectively agrees to buy the bond or security back from the "buyer" at a later date. The RBA prefers using repos to conduct DMO because they are highly flexible instruments and can be used to manage ES supply much more precisely than outright purchases or sales of financial securities.

In summary, the RBA uses the cash rate policy corridor to implement changes to the cash rate target, and can use DMOs to ensure that the cash rate stays consistent with the target every day when the demand for ES funds changes. The RBA expects that ES balances will decline over the next few years as funding provided to banks unwinds and the RBA's holdings of government bonds mature.

## The transmission of the cash rate to other interest rates

The cash rate is often called the foundation or the anchor of the interest rate structure in the Australian economy. This simply means that the cash rate has a major influence on many other interest rates in Australia. It has this influence because it affects how much it costs financial institutions such as banks to fund themselves. An increase in the cash rate means that it becomes more expensive for financial institutions to obtain funds in the short-term money market (and generally other funding markets too). To maintain their profit margins financial institutions generally respond by increasing the interest rates that they charge to borrowers, such as on household mortgages used to buy houses. Similarly, a reduction in the cash rate lowers the funding costs for banks and other financial institutions (that is, it costs them less to borrow money), and competition between financial institutions causes them to pass this cost saving on to their customers in the form of lower lending interest rates.

However, factors other than the cash rate also influence the main interest rates in the economy (home loans, credit cards, personal loans and commercial loans). These include competition in the banking sector, regulations, conditions in global and domestic financial markets and risk assessments relating to economic conditions. This means that the margin or difference between the cash rate and those other interest rates can change over time in response to these other factors.

The Reserve Bank can either tighten monetary policy by raising the cash rate target, or loosen monetary policy by lowering the target. The impacts of the Reserve Bank's implementation of monetary policy are summarised in figure 15.3.

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| Monetary policy stance | Cash rate target | Policy rate corridor | Overnight money market | Cash rate | Market interest rates |
|---|---|---|---|---|---|
| ***Tightening*** | Increases | Shifts upward | Influenced by RBA to ensure cash rate is consistent with target | Rises | Rise |
| ***Loosening*** | Decreases | Shifts downward | Influenced by RBA to ensure cash rate is consistent with target | Falls | Fall |

**Figure 15.3 –** The conduct of monetary policy

While announcements of changes in the cash rate are the most important statements by the RBA, other releases such as board minutes and speeches by key RBA officials are also scrutinised closely by markets. Financial markets often interpret small changes in the RBA's description of economic conditions as a signal of future interest rate movements. Markets can "price in" a future interest rate increase or decrease even before it has happened. This can result in interest rates in financial markets changing before the RBA changes the cash rate target.

## Unconventional monetary policy

In recent years, central banks have gone beyond the traditional usage of interest rates to implement monetary policy, and have experimented with additional measures. This became necessary because, with interest rates already close to zero, further stimulus to the economy required other policy instruments. While other central banks had adopted several of these measures in response to the global financial crisis of 2007–2009, it was in response to the COVID-19 recession that the RBA implemented these measures in Australia:

- Asset purchases: purchasing government securities in the secondary market from financial institutions and paying for them by depositing newly created ES balances in their accounts
- Forward guidance: using official communications about the future stance of monetary policy to influence current interest rates on longer-term assets
- More liquidity: the RBA increased the size of its DMO compared to normal, and created the Term Funding Facility which provided cheap additional loans to commercial banks to support them lending more to households and businesses
- Changing the size of the corridor: by setting the corridor floor to 0.1 percentage points below the cash rate target (instead of 0.25 percentage points), the RBA was able to lower the cash rate to 0.1 per cent without the risks of negative interest rates.

These measures were largely unwound in the second half of 2021 as Australia's recovery from the pandemic took hold.

The use of tools other than a central bank's main policy interest rate (the cash rate in Australia) is often called unconventional monetary policy. In this instance, the term "unconventional" refers to the fact that central banks in advanced countries have only begun using these tools in the past two decades, and mostly in response to extreme economic events. This is in contrast to conventional monetary policy, when central banks use interest rates as their main tool.

Negative interest rates are another form of unconventional monetary policy, and they have been implemented in Japan, the European Union and Sweden. However, the RBA has consistently stated that it is very unlikely to introduce negative interest rates.

One way to think about the influence of unconventional monetary policy is through the yield curve. This curve shows how, in general, loans of longer maturity tend to have higher interest rates because lenders expect higher returns to compensate for the greater risks involved with lending out money for a longer period of time. Unconventional monetary policy measures generally work by reducing interest rates specifically on longer term loans.

**Appendix B:** In 2020, a controversial theory on inflation and monetary policy called modern monetary theory (MMT) gained prominence. For an explanation, see Appendix B (section B.4).

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While conventional monetary policy usually lowers the entire yield curve – reducing interest rates across the board – unconventional measures typically flatten the curve, as shown in figure 15.4. This flattening represents the additional stimulus provided by unconventional monetary policies.

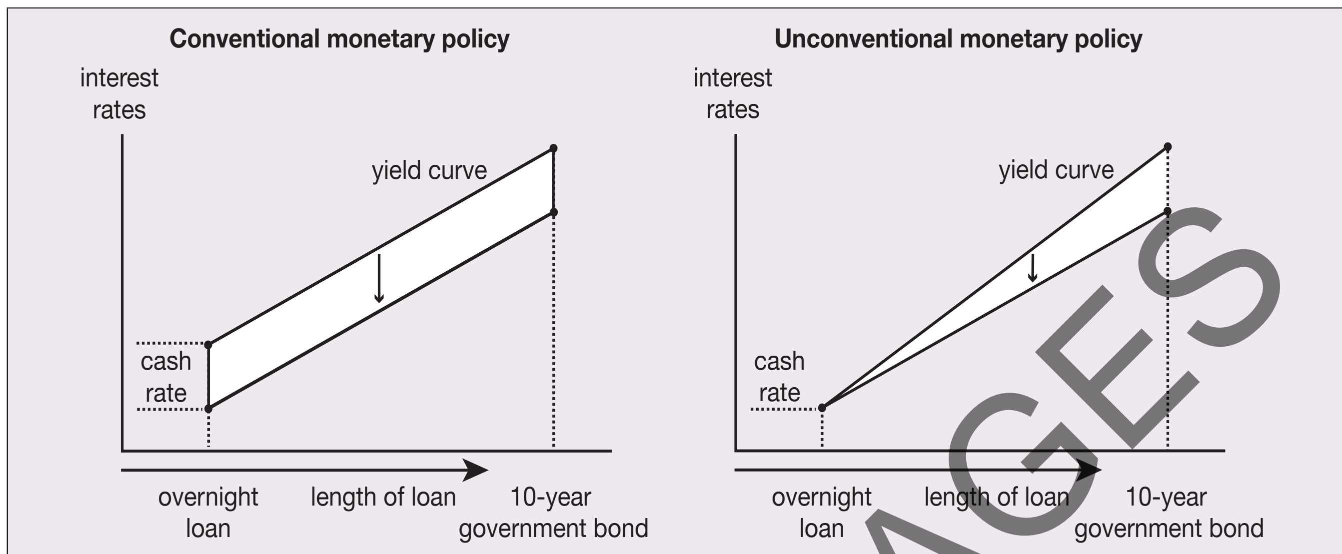


**Figure 15.4 –** Impact of conventional and unconventional monetary policy on the yield curve

SAMPLE PAGES

## reviewquestions

1. Explain how interest rates are determined in Australia with reference to *domestic market operations*, *exchange settlement accounts* and the *cash rate*.
2. Identify the impact of the following transactions on the supply of funds in the short-term money market and their impact on the cash rate.
   a) The Reserve Bank buys Commonwealth Government Securities from a bank.
   b) The Reserve Bank sells Commonwealth Government Securities to a financial institution.
3. Explain the difference between conventional and unconventional monetary policy.

## 15.4 The impact of changes in interest rates

**Transmission mechanism** explains how changes in the stance of monetary policy pass through the economy to influence economic objectives such as inflation and economic growth.

Economists often describe the process through which monetary policy affects the economy as the **transmission mechanism** of monetary policy. The transmission mechanism works through a number of different channels:

- Downward pressure on interest rates through expansionary monetary policy makes borrowing cheaper for consumers and businesses. Consumers often need to borrow to make major purchases such as housing and consumer durables. Similarly, businesses borrow for the purposes of investment in capital, plant upgrades and expansions. In addition, the interest rate they can obtain by investing in financial assets represents an opportunity cost of investing funds in the business for business owners. Thus, a fall in the level of interest rates should **encourage borrowing by both businesses and consumers**, leading to rising consumption and investment demand in the economy. This raises the overall level of economic activity.

- Reduced interest rates also have an effect on businesses and consumers that already have loans since the cost of servicing existing loans becomes cheaper. This means that existing borrowers can use more of their income on **additional spending** rather than servicing their loans. This is often called the cash flow channel of monetary policy.
- A fall in the level of interest rates also discourages financial inflows into Australia, which, as discussed in chapter 5, leads to a **depreciation** of the currency. A depreciation of the Australian dollar makes Australian goods relatively more competitive in both domestic markets (since imports are more expensive) and overseas markets. This consequence of a fall in the level of interest rates also stimulates aggregate demand and could add to inflation.
- Lower interest rates also can cause asset prices to increase for a range of assets including houses and shares in public companies. Higher asset prices provide asset holders (such as home owners) with more wealth, which they often use to consume and invest more than they otherwise would. This is frequently called the wealth channel of the transmission mechanism.

All of the channels described above cause aggregate demand to increase when interest rates are lower. This typically generates higher economic activity and employment (particularly if the economy was previously in recession), but could spill over into higher prices and wages if the economy was already close to full employment. The transmission mechanism would work in the opposite direction if the RBA put upward pressure on interest rates through contractionary monetary policy.

Overall, a **tightening** of monetary policy puts upward pressure on interest rates, which has the effect of dampening consumer and investment spending, resulting in a lower level of economic activity, with lower inflation and the possibility of higher unemployment. On the other hand, a **loosening** of monetary policy puts downward pressure on interest rates, boosting consumer and investment spending, resulting in a higher level of economic activity, with falling unemployment, and often an increase in inflationary pressures.

Debate about the impacts of interest rate movements was sparked recently by a research paper arguing that the most effective channel through which monetary policy affects inflation is actually via the exchange rate. The paper, published in 2022 by economists Isaac Gross and Andrew Leigh (also an Assistant Minister in the Federal Government), concluded that if interest rates increase relative to interest rates overseas, this makes holding cash in AUD-denominated assets more attractive and the exchange rate appreciates. This lowers some prices directly (such as prices for imports), reduces input costs, increases competition and reduces aggregate demand (because exports become more expensive). The challenge for policymakers is that the effectiveness of the exchange rate channel in Australia depends on monetary policy decisions made in other countries – that is, if other countries also increase interest rates, Australia's exchange rate may not appreciate, and the change in monetary policy will have limited impact.

While a change in monetary policy can be implemented almost immediately (that is, it does not require legislation or parliamentary approval), it can take considerably longer for that change to bring about the desired impact on economic growth, inflation and unemployment. Monetary policy can have a **time lag** of around 12 to 24 months before the full impact of interest rate changes are felt in the economy. This time lag can sometimes pose problems for policymakers. Economic circumstances can change substantially during the relatively long lag period and make current monetary policy inappropriate. For example, a series of interest rate increases which lower consumption and investment may still be constraining economic activity at a time when a recession occurs and looser monetary policy is needed to restore price stability. This is why the RBA usually focuses on the likely economic conditions in 12 to 24 months' time when it sets monetary policy. For this reason, the RBA invests considerable resources into forecasting future values of macroeconomic variables, including GDP, inflation and unemployment.

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## reviewquestions

**1** Explain what is meant by the monetary policy *transmission mechanism*.

**2** For each of the following scenarios, explain how DMO might be used to influence the economy and what impact these changes would have.

a) A shortage of skilled workers is putting upward pressure on wages growth and creating inflationary pressures.

b) Global economic growth is raising demand and prices for raw materials and commodities that are used as inputs to production.

c) A fall in consumer and business confidence causes reductions in consumption and employment growth.

**3** Describe the role of time lags in the conduct of monetary policy in Australia.

**Appendix B:** "Advanced Economic Analysis" at the back of this textbook looks at the implementation and limitations of monetary policy in more detail.

## 15.5 The stance of monetary policy in Australia

The RBA communicates the stance of monetary policy in its cash rate target announcement following each Board meeting, and publishes official minutes from the meeting two weeks later.

After the recommendations from the review of the RBA are implemented, the RBA will communicate the stance of monetary policy by making a cash rate target announcement after each meeting of the Monetary Policy Board. Immediately after the announcement, the Governor will give a press conference and the Board will release a public statement outlining the discussion and votes at the meeting.

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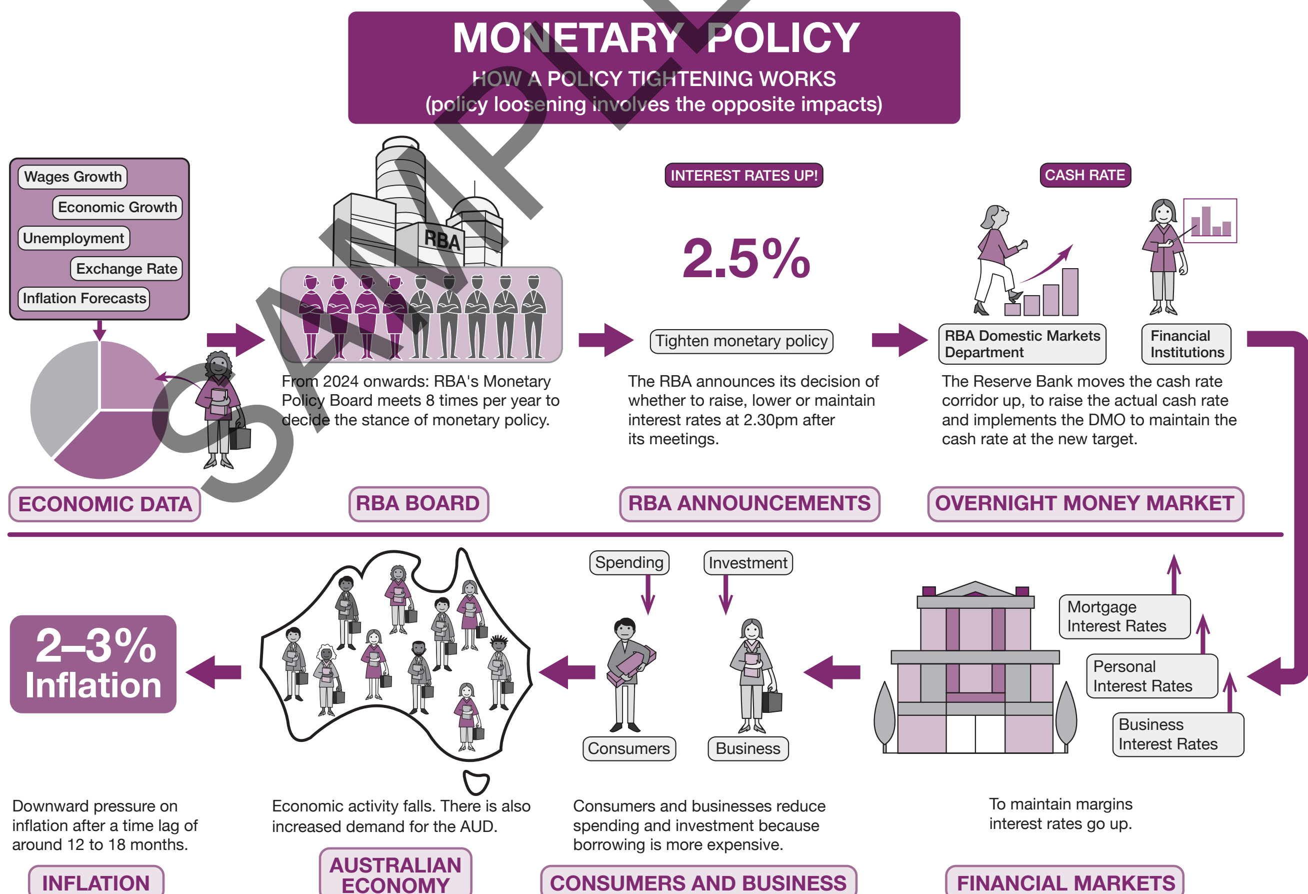

The stance of monetary policy is further reflected by broader interest rate changes in the economy. Interest rates in Australia have varied considerably over time as monetary policy has been altered to respond to varying economic conditions (see figure 15.5). As the graph shows, there have been periods of both rapid interest rate reductions (in the early 1990s and late 2000s) and periods of rapid increases (in the mid-1990s and early 2020s). There have also been periods of slow increases (in the 2000s) and slow decreases (in the 2010s).

## HOW FAST IS TOO FAST?

By July 2023, the Reserve Bank had increased the cash rate 12 times (including 10 consecutive increases) from its pandemic low of 0.1 per cent as it sought to keep rising inflation under control.

The increases in interest rates were a necessary response to the high inflation and low unemployment being experienced in the Australian economy. However, some economists argued that the increases were too fast. In July 2023, AMP chief economist Shane Oliver noted "the more you raise rates the more you could tip [the economy] over the edge".

In response to the interest rate increase in June 2023, Treasurer Jim Chalmers warned "there will be a lot of Australians who will find this decision difficult to understand and difficult to cop", urging the Reserve Bank to defend its decision. For mortgage holders, monthly repayments on an average $600,000 mortgage increased by almost two-thirds (from $2,185 to $3,559 over the 12 increases), sending many households into mortgage stress. Other arguments suggested that the pace of increases did not allow time for the changes to take effect, due to the long and variable monetary policy lags. Economist Ross Garnaut noted in May 2023 that "the responsible thing is to pause until we see those effects [of lifting interest rates]".

Overall, Australia's experience of rising interest rates has been moderate, with interest rates below those in the UK, Europe and North America. Perhaps the most extreme example elsewhere is in Türkiye, where the central bank is not independent from the government. To avoid an increase in interest rates or a downturn during the election campaign, Türkish President Recep Tayyip Erdogan sacked three central bank governors in quick succession. Once re-elected, and with official inflation rising above 40 per cent, Erdogan appointed a central banker who, in one move, raised interest rates from 8.5 per cent to 15 per cent, sending the economy into a sharp downturn.

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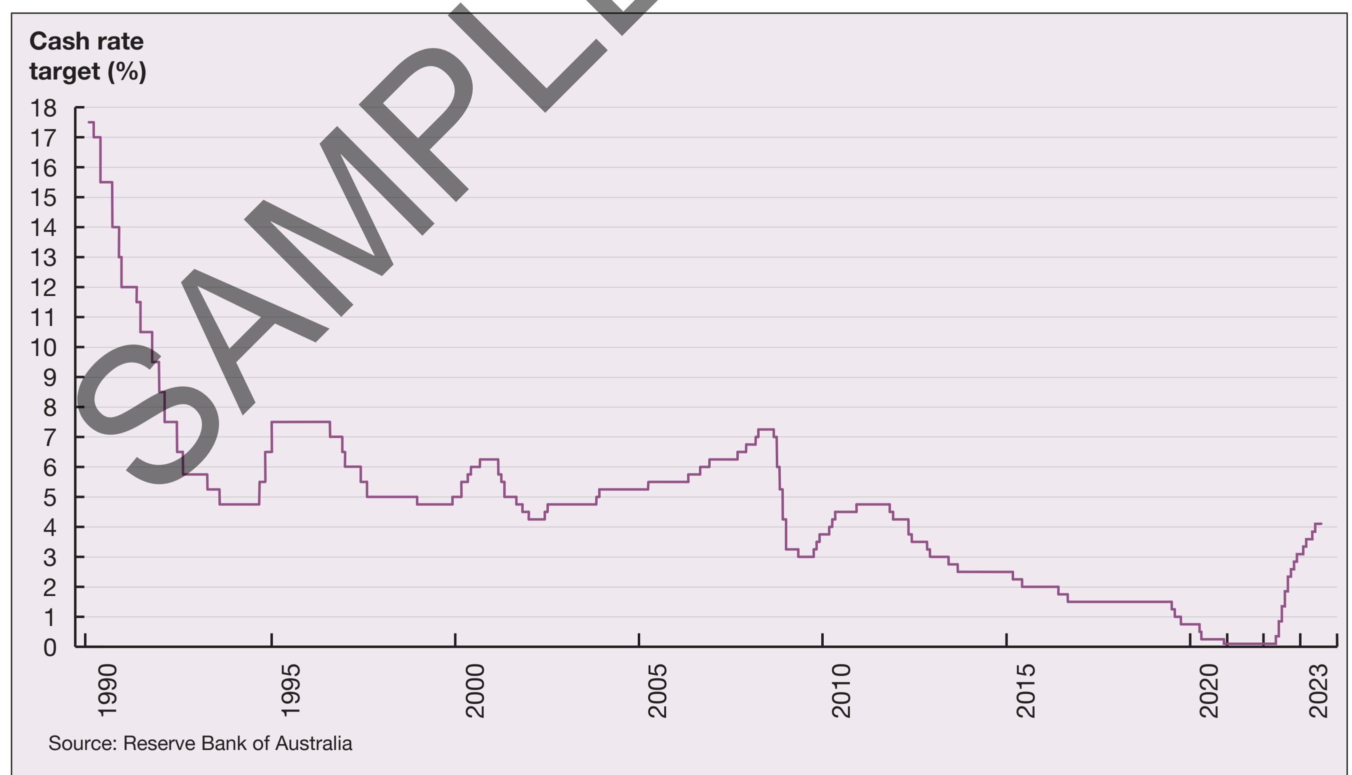


**Figure 15.5** – Australian cash rate

Monetary policy was made very expansionary in response to COVID-19. Even before the onset of the pandemic, the cash rate target had reached historically low levels in response to a period of weak growth and low inflation. Since the pandemic placed substantial downward pressure on economic growth, inflation and employment, the cash rate target was lowered further to 0.10 per cent, its lowest level ever. In addition, the RBA introduced several unconventional monetary policy measures that further eased the stance of monetary policy. All of this monetary support helped the Australian economy successfully recover from the worst of the pandemic in 2020 and 2021. However, significant inflation pressures emerged in Australia in 2022 and 2023 due to global supply chain issues arising from the pandemic, the war in Ukraine, high levels of inflation overseas, labour shortages, and strong aggregate demand – partly reflecting the extent of stimulus provided by governments. The RBA responded to rising inflation with a series of rate increases, lifting the cash rate above 4 per cent.

Overall, the RBA has generally been successful in controlling the level of inflation. However, prior to the COVID-19 pandemic, the RBA was criticised for inflation being too low and for making economic forecasting and policy errors. In the years leading up to the pandemic, inflation remained below the RBA's target, averaging around 1.6 per cent from 2016 to 2019. Some commentators blamed this on the stance of monetary policy not being expansionary enough at the time. Others argued that the RBA's policy stance during COVID-19 was too expansionary and its "forward guidance" that the cash rate was very unlikely to be raised until 2024 reflected bad economic judgment. These concerns helped prompt the independent review of the RBA released in 2023.

| | |
|---|---|
| **Early 2000s** | Monetary policy is tightened to deal with the inflationary consequences of the depreciation of the exchange rate and the introduction of the Goods and Services Tax. |
| **Mid-2000s** | Expansionary monetary policy to support growth during a mild downturn, followed by gradually increasing interest rates as inflationary pressures emerge during the boom in commodity prices. |
| **2008–2009** | Concern about the potential impacts of the global financial crisis on Australia sees the RBA slash the cash rate to 50-year lows of just 3 per cent. |
| **2009–2011** | Monetary policy returns to a more neutral position as the crisis eases, with the cash rate rising to 4.75 per cent by late 2010. The domestic recovery and strong mining sector growth sees the RBA refocus on containing inflationary pressures. |
| **2011–2018** | Monetary policy remains expansionary for a long time period, against the backdrop of low inflation and below-average economic growth. The cash rate target reached a historic low of 1.5 per cent in 2016, where it remained until 2019. |
| **2019–2021** | Subdued economic conditions, modest employment growth and low inflation motivated the RBA to ease monetary policy further. In 2019 the cash rate target was gradually lowered to 0.75 per cent. Following the outbreak of COVID-19, the RBA slashed the cash rate target to 0.1 per cent and introduced a range of unconventional measures to strengthen the financial system and support growth. |
| **2022–** | The RBA responded to rising inflation by sharply increasing interest rates, earlier than it had expected, with 12 interest rate increases between mid-2022 and mid-2023, leading to a cash rate of above 4 per cent. |

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There are five main factors that help to explain the stance of monetary policy:

1. The **low inflation objective**: Both the government and the Reserve Bank are committed to maintaining the RBA's inflation target – an average rate of inflation between 2 to 3 per cent. Monetary policy is the major tool used to achieve this outcome.
2. **Inflationary expectations:** One key element in the government's strategy of achieving low inflation is reinforcing expectations of sustained low inflation. If inflationary expectations remain low, businesses will plan lower price increases and unions will seek lower wage rises. The RBA will raise and maintain high interest rates if necessary to reduce inflationary expectations.
3. **Labour costs:** Future interest rate movements are dependent upon movements in the level of inflation, and one of the most significant determinants of inflation is the cost of labour trends in productivity growth. The best indicator of wages growth is the Wage Price Index released by the Australian Bureau of Statistics (ABS).
4. The RBA remains committed to achieving **low unemployment** and promoting economic prosperity. The level of growth and unemployment are also important indicators of whether the economy is close to its supply constraint. If the economy is operating at a point that is close to capacity (that is, close to full employment of labour and other resources), continued growth in spending and demand will not lead to higher output and employment, and will instead spill over into higher prices.
5. **External factors**: Australia's integration with the global economy means that international conditions consistently influence RBA monetary policy settings. For example, if global conditions deteriorate, Australia is more likely to face slower economic growth and higher unemployment, and the RBA may move to reduce interest rates to prevent a downturn. More broadly, the RBA monitors conditions in global financial markets for any early warning signs of inflationary pressure or economic volatility so that it can move pre-emptively to change monetary policy settings. The RBA also assesses external factors because the exchange rate channel is an important component of the transmission mechanism of monetary policy.

## reviewquestions

1. Examine recent changes in the stance of monetary policy in Australia.
2. For each of the following scenarios, propose an appropriate monetary policy response (and justify your decision).
   a) A rise in petrol and natural gas prices increases inflation but lowers consumer spending.
   b) A recession overseas causes the Australian dollar to depreciate and increases domestic unemployment.
3. Explain how wages growth may impact monetary policy decisions.

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# chapter summary

1. **Monetary policy** involves actions by the **Reserve Bank of Australia** to influence the cost and supply of money and credit in the economy, in order to achieve the government's policy objectives.

2. Monetary policy is the main **macroeconomic policy** instrument used to influence the level of economic activity in the short to medium term.

3. The **objectives** of monetary policy are low inflation and maintaining full employment – with an overarching purpose of promoting economic prosperity for Australians. Its primary goal is to contain inflation within a target range of 2–3 per cent on average, over the course of the economic cycle.

4. Like many other industrialised nations, Australia adopted an **inflation-targeting** monetary policy regime in the early to mid-1990s that has generally proved successful in sustaining low inflation and relatively stable economic growth.

5. The **objectives** of monetary policy are often in conflict, since faster economic growth and job creation tend to be associated with higher levels of inflation.

6. Monetary policy is implemented through **domestic market operations** – the purchase and sale of second-hand government securities by the Reserve Bank in the short-term money market for the purpose of influencing interest rates.

7. When the RBA sells government securities in the short-term money market, it reduces the supply of funds, and this results in higher interest rates. The RBA implements this policy when it wants to slow down the level of economic growth and reduce inflationary pressures. Alternatively, if it wants to accelerate growth, the RBA buys government securities, increasing the supply of funds and reducing interest rates.

8. In recent years the Reserve Bank has deployed several **unconventional monetary policy measures** to support growth, stabilise financial markets, encourage lending and influence market expectations. These measures have been used when conventional monetary policy measures (interest rates) have reached the limits of their effectiveness.

9. Interest rate changes affect the economy through the monetary policy **transmission mechanism**, in which lower interest rates encourage increased consumer spending and business investment, raising the level of aggregate demand. Higher interest rates dampen aggregate demand by discouraging consumer spending and business investment.

10. In making monetary policy decisions, the **RBA's Monetary Policy Board** considers a number of economic indicators that are likely to affect its policy goals over the coming year, including inflation, inflationary expectations, wages growth, the rate of economic growth, the unemployment rate, interest rates overseas, the exchange rate and the balance of payments.

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# chapter review

1. Define *monetary policy*.
2. Outline the broad objectives and overarching purpose of monetary policy.
3. Identify what is meant by *inflation targeting* and why it has been implemented in Australia.
4. Explain what is meant when we describe Australia's inflation target as a *flexible target*.
5. Identify the economic indicators monitored by the government and the Reserve Bank to determine whether a change in monetary policy is necessary.
6. Explain how the RBA conducts *domestic market operations*.
7. Outline what action the Reserve Bank would take if it wanted to:

    a) tighten monetary policy

    b) loosen monetary policy
8. Discuss how changes in interest rates influence the level of economic activity.
9. Discuss how Australia's growth and inflation levels have influenced the conduct of monetary policy in recent years.
10. Outline how time lags influence the implementation of monetary policy.

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# 16 Microeconomic and Environmental Policies

16.1 Microeconomic policies and aggregate supply
16.2 Microeconomic policies and individual industries
16.3 Environmental management policies

## 16.1 Microeconomic policies and aggregate supply

**Microeconomic policies** are government actions that aim to increase aggregate supply by improving the efficiency and productivity of producers and industries.

**Microeconomic policies** are actions taken by governments to improve the efficiency of firms and industries in order to maximise the amount of output that can be produced from the scarce resources available in an economy. Microeconomic policies are central to the government's long-term aim of increasing the level of sustainable growth in Australia and reducing the extent to which inflation and external imbalances constrain economic growth.

Microeconomic policies are also important because many of Australia's economic problems are caused by structural factors. Macroeconomic policies can only manage the level of economic activity in the short term. Interest rate changes and automatic stabilisers cannot readily address structural issues in Australia such as labour market skill shortages or decarbonising our energy and transport systems. Lifting Australia's longer term growth requires structural changes to increase productivity in existing industries and help Australia transition successfully to new industries, such as fast-growing knowledge-based services and green energy. Microeconomic reforms include tax reform, improving the education system and supporting investment in technology infrastructure.

Microeconomic policy is different from macroeconomic policy because microeconomic policies influence supply rather than demand. It is therefore sometimes called **supply-side economics**. The ultimate focus of supply-side economics is to increase aggregate supply, which shifts the aggregate supply curve to the right – the result is that more goods and services are provided at lower prices. This is shown in figure 16.1. Policies that focus on increasing the level of aggregate supply do so by improving the competitiveness, productivity and efficiency of Australian industries.

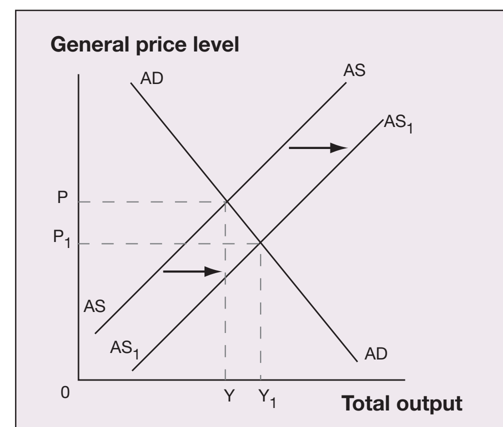


**Figure 16.1 –** Increasing supply as a result of microeconomic reform

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Microeconomic policies are closely associated with structural change. **Structural change** refers to shifts in the pattern of production that reflect changes in technology, consumer preferences, policy, global competitiveness and various other factors. It results in the decline of products, processes, and even industries, while facilitating the emergence of others. Microeconomic policies promote structural changes and help the Australian economy respond more effectively to changing economic conditions by making product and factor markets work more efficiently. **Product markets** include the market for goods, such as motor vehicles, and services, such as transport. **Factor markets** are markets for the inputs to production, such as the labour market and financial markets. Markets work efficiently when goods are produced at the lowest cost, and resources flow to areas where they have the highest value.

**Structural change** involves shifts in the pattern of production that reflect changes in technology, consumer preferences, global competitiveness and other factors. It results in some products, processes and even entire industries disappearing, while others emerge and become more prominent.

The structure of the Australian economy has changed in recent decades because of improvements in technology, increased trade, changes in patterns of consumer preferences and the implementation of wide-ranging microeconomic policies between the early 1980s and the beginning of the 21st century. For example, figure 16.2 shows a significant shift in the allocation of resources in Australia away from manufacturing and towards the mining sector since the 1980s. As we will see in the next section, long-term trends can be at least partly explained by the impact of microeconomic policies.

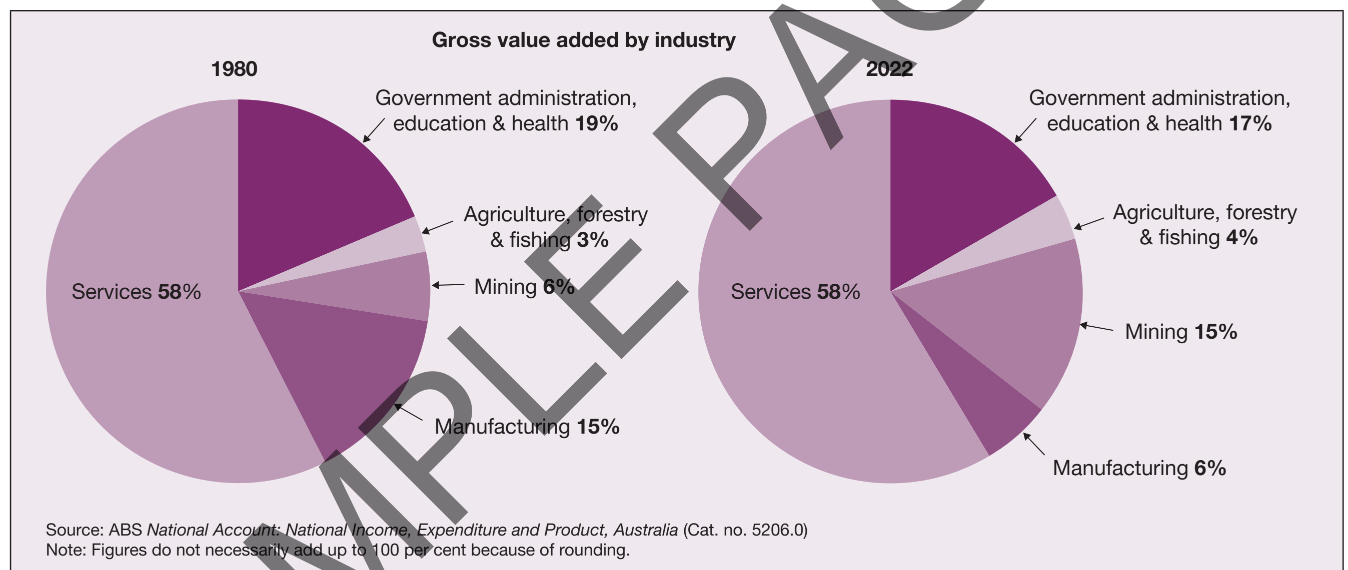


**Figure 16.2 –** The changing industrial structure of Australia's economy

Microeconomic theory says product and factor markets will generally be more efficient if there is greater competition between private businesses, and the market forces of supply and demand are able to operate with fewer distortions, either from government policies or anti-competitive market conduct. For example, electricity is a major input to production and a necessity for households. The price of electricity is highly regulated. This may lead to lower prices for households in the short term but lower investment in new energy generation facilities in the long term, if investors expect that price regulation will lead to lower profits. Underinvestment in energy generation infrastructure could lead to less reliable energy supply, lower productivity and higher energy prices. Some advocates of microeconomic reform regard price regulation in the electricity sector as a distortion of market forces that should be removed. Others, however, regard such regulation as necessary to prevent large energy firms from exploiting their market power and extracting excessive profits.

Microeconomic policies can operate on different levels, from decisions by an individual government official about a single company to sweeping policies for entire industries. The overriding goal of microeconomic reforms is to **encourage the efficient operation of markets** – to lift productivity, improve flexibility and responsiveness to change, and encourage Australian firms to take on "world best" practices in order to increase aggregate supply.

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There are three dimensions to improving the efficiency of markets: **allocative, technical** and **dynamic efficiency**. However, many microeconomic policies will have impacts on all three aspects of efficiency simultaneously, potentially blurring the distinctions between the concepts. For example, past reforms to Australia's telecommunications industry have increased competition, forcing companies to become more technically efficient to maintain and improve market share. The forces of competition have also encouraged innovation and dynamic efficiency, attracting more investment to the telecommunications industry (a sign of allocative efficiency). Nevertheless, it is useful to identify the specific ways in which

## ALLOCATIVE EFFICIENCY

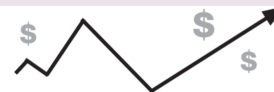
**Allocative efficiency** refers to the economy's ability to shift resources to where they are most valued and can be used most efficiently.

By minimising the distortions to the market economy (such as the impact of government regulations, tax loopholes, subsidies and anti-competitive behaviour), the operation of market forces should bring about a more efficient allocation of resources. In a free market economy, resources should shift to those producers who have the greatest capacity to pay, and that capacity to pay will reflect relative efficiency and value to the economy (more efficient producers stand to make greater profits from production and so are willing to pay more for resources). Achieving allocative efficiency promotes beneficial structural change by allowing resources to flow to those areas where they are used most efficiently. For example, economists argue that the removal of tariff protection has led to a reallocation of resources away from inefficient producers who could only survive behind tariff barriers towards the more efficient producers who are competitive without protection.

## TECHNICAL EFFICIENCY

**Technical efficiency** refers to the economy's ability to produce the maximum level of output from a given quantity of inputs.

Technical efficiency is the ability of an economy to achieve the maximum level of output from a given quantity of inputs. Technical efficiency is measured by the productivity of a business or an economy: that is, how much output can be produced from a given quantity of inputs. Greater productivity means that businesses can produce output more cheaply, which makes them more competitive in domestic and global product markets. Businesses operating in a competitive market therefore have very powerful financial incentives to maximise technical efficiency. They will be more inclined to adopt the latest production technology and use the least-cost combination of resources to produce.



The **finance and insurance industry** achieved higher multifactor productivity growth (measured across both labour and capital inputs) than most other sectors in Australia during the period from 1997 to 2022, recording average annual productivity increases of around 1.5 per cent. In contrast, average annual productivity growth in Australia's manufacturing sector was around 0.4 per cent over the same period. Industry changes that contributed to increased productivity in the finance sector include online banking, the automation of information processing, closures of local bank branches and reduced staffing, offshoring of some processing functions and organisational restructuring. Policy decisions and structural changes in past decades contributed to these changes, including deregulation, privatisation and increased competition for traditional financial institutions.

## DYNAMIC EFFICIENCY AND INNOVATION

**Dynamic efficiency** refers to the economy's ability to shift resources between industries in response to changing patterns of consumer preferences.

Dynamic efficiency means that producers are able to respond quickly to changing patterns of demand in both the domestic and global economy. For example, a dynamically efficient car manufacturer would be able to shift relatively quickly from producing petrol cars to producing electric vehicles as consumers become more concerned about fuel emissions. In addition, producers who are dynamically efficient are able to adopt new technologies and innovative business practices. One of the major ways in which microeconomic reforms can increase dynamic efficiency is by increasing the level of competition in industries, which will tend to force producers to be more responsive to changes in demand and supply.

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individual microeconomic reforms have affected the allocative, technical and dynamic efficiency of specific sectors in the Australian economy.

In the following section we look at industries and how they have been affected by a range of microeconomic policies, including deregulation, reforms to public trading enterprises and competition policy. In section 16.3 we look at the national and global context for environmental management. Although the ultimate objectives of environmental policies are different to microeconomic policies, they are included in this chapter because of the similar way in which they affect households, businesses, industries and the economy. Moreover, climate change, and policies introduced in response, will likely cause the most influential structural changes to the economy over the coming decades. It is also important to note that as well as the policies covered in this chapter, examples of other microeconomic policies are provided in several other chapters in topics 3 and 4.

| MICROECONOMIC REFORM POLICIES |
| --- |
| Deregulation |
| Reforms to public trading enterprises |
| Competition policy |
| Environmental management |
| Reducing protection – see chapter 6 |
| Tax reforms – see chapter 14 |
| Labour market reforms – see chapter 17 |

## reviewquestions

1. Define *microeconomic policy*.
2. Describe the THREE different types of efficiency that microeconomic policies aim to improve.
3. Explain how microeconomic policies promote or respond to structural change and increase aggregate supply.

# 16.2 Microeconomic policies and individual industries

## Deregulation

**Deregulation** involves the simplification or removal of rules that constrain the operation of market forces, and it aims to improve the efficiency of industries. The process of deregulation has driven extensive structural change in many industries.

### Financial sector

The financial sector plays an important role in ensuring that businesses can access funds for investment and growth, and investors can easily and confidently invest their savings in various ways. Microeconomic policies in the financial sector in the 1980s aimed to make the sector's provision of these services more efficient and competitive. The first step in financial deregulation was the floating of the Australian dollar, and the removal of the Reserve Bank's direct monetary controls over banks, which gave them more autonomy to set interest rates on their deposit accounts and loans consistent with market forces. The second was the removal of barriers to foreign banks entering the Australian market.

Financial deregulation has resulted in a more competitive environment for many financial services. The benefits of a more competitive financial sector are spread across the entire economy, as consumers and businesses pay lower prices to access finance that is better geared to their needs. Better access to finance can facilitate more consumption by individuals and more investment by businesses.

The global financial crisis of the late 2000s resulted in some businesses in the financial sector collapsing or being acquired by other businesses, reducing competition in the financial sector. In many countries, the financial crisis was also blamed on governments

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having gone too far in deregulating the financial sector, allowing banks to take too many risks with depositors' money. This highlights the need for a balance between the goals of efficiency and competition (which generally favour deregulation) and the goals of consumer protection and financial system stability (which generally favour regulation).

Finding this balance was the overarching aim of the Financial System Inquiry (also known as the Murray Review), a policy review of Australia's financial sector conducted in 2014. It led to an increase in the minimum capital requirements for banks to make them more resilient to future financial crises. It also resulted in the removal of rules imposing tougher capital requirements on smaller banks compared with larger banks. The increased capital that was built up in Australian banks as a result proved useful during the COVID-19 crisis, as banks were well-positioned to support lending to businesses during the economic downturn. In that sense, the finance sector was part of the solution to the economic crisis in 2020, whereas it was part of the problem during the economic crisis of 2008. Consumers have also benefited from laws banning excessive credit card surcharges since 2016 (another recommendation from the inquiry).

Tensions between consumer protection and efficiency were highlighted in the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry in 2019. The Royal Commission uncovered a range of dishonest practices, including breaches of industry codes of practice, failings on contracts, and widespread mistreatment of customers. It also found widespread governance problems at senior levels in financial institutions, and major flaws in how the industry was regulated by the Australian Securities and Investment Commission (ASIC).

The Royal Commission concluded that the current laws and regulations remain largely appropriate, but that these rules require stricter enforcement and harsher penalties. Regulatory agencies subsequently adopted a tougher approach to litigation-enforcing regulations, reflected in several high-profile court cases against banks and other finance companies, including allegations that Westpac Banking Corporation breached responsible lending laws when extending housing loans to some customers, and that the National Australia Bank had charged superannuation customers fees without providing any financial services. The Commission did not recommend major legislative changes, despite the problems it uncovered, because of concerns that introducing more regulations might make it harder to obtain credit in Australia, especially for small businesses.

### Agricultural industries

Deregulation in the agricultural sector has created more competition in markets for farm produce. In the past, single government-owned businesses or industry cooperatives had a monopoly on buying farmers' produce in areas such as dairy, wheat and wool. With deregulation those monopolies ended, and farmers were given new incentives to innovate and diversify their outputs. Combined with tariff reductions, these changes transformed Australia's agricultural sector from a highly regulated industry to one of the least regulated agricultural industries in the world. Australia's agricultural output expanded significantly in the years after deregulation. Nevertheless, over the past two decades, growth in agricultural productivity has slowed considerably. Average annual productivity growth in the broadacre agricultural industry (all agriculture production except for dairy products) has been sluggish since the start of the 21st century. In contrast, annual average growth in agricultural productivity was around 2 per cent over the second half of the 20th century. Evidence from the Australian Bureau of Agricultural and Resource Economics and Sciences suggests that this decline can partly be attributed to deteriorating climate conditions. Recent productivity estimates that attempt to account for climate conditions (both short term and long term) are higher than the unadjusted estimates that do not account for changes in climate, although the difference is relatively small.

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## Transport industries

Transport industries are crucial to Australia's economy because of the large distances within Australia, and between Australia and other nations. Two key examples of deregulation in Australia's transport industries are:

1. Australia's **domestic aviation** industry is dominated by two airline groups: Qantas/Jetstar and Virgin Australia. In some respects, its structure is similar to when the sector was deregulated in 1990, abolishing the official Two Airline Policy in place since 1952. Several airline businesses have entered the Australian aviation market since 1990, but have struggled to compete against the major carriers. Two smaller airlines, Rex and Bonza (which commenced operations in 2023), mainly compete on regional routes. According to a 2023 report from the Australian Competition and Consumer Commission, a lack of competition helps explain why Australia's aviation industry has underperformed for domestic travellers in recent decades (in terms of prices and service quality). The Government's Aviation White Paper, expected in 2024, aims to strengthen competition and improve outcomes for consumers.
2. **Rail:** The efficiency of the rail freight industry has undergone significant reforms over recent decades. In 1997, the Commonwealth and state governments established the Australian Rail Track Corporation (ARTC) to manage the 10,000- kilometre national interstate rail network. The ARTC sells access to privately owned freight businesses such as Pacific National and oversees maintenance of the network and new capital works. Establishing corporations at arms-length from government, however, does not guarantee efficient operations, however. A 2023 review of Inland Rail by Dr Kerry Schott, found the 1,700 kilometre infrastructure project that runs through the eastern states had been poorly managed and experienced an "astonishing" cost-blowout. Part of the reason was a government failure to appoint people to the board with the necessary freight rail or infrastructure skills.

## Telecommunications industry

Telecommunications is an important contributor to productivity, and as a sector contributes around 2 per cent of economic output. The dominant role in the industry is still held by Telstra (formerly a government-owned monopoly called Telecom Australia), but the industry has been transformed by competition since it was deregulated in the 1990s. A combination of new technologies and competition lowered telecommunications costs dramatically. New market entrants successfully competed in different product and service markets, including internet service providers, mobile carriers and providers of business services. Nevertheless, Telstra still retained its role as the largest firm in the industry.

For many years Telstra was accused of making it difficult for competitors to gain access to its local monopoly over residential phone connections. For this reason, the decision was made during the rollout of the National Broadband Network (NBN) in the 2010s to separate the wholesale business of providing access to the infrastructure from the retail businesses that offer telecommunications services to households and businesses. The goal of these changes was to improve access in order to increase competition among retailers while also making high-speed internet access more widely accessible.

### Effective regulation

Effective deregulation involves striking a balance between competing policy goals. Excessive regulation can increase costs, reduce investment, discourage new market entrants and ultimately lower economic growth. On the other hand, excessive deregulation (or to put it another way, inadequate regulation) can lead to market failure (such as a lack of competition) and economic instability. This tension is especially apparent in the finance industry because financial crises have flow-on effects across the whole economy.

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## MAKING DIGITAL GIANTS PAY FOR NEWS CONTENT

One example of new regulation in response to technology change is the News Media and Digital Platforms Mandatory Bargaining Code, introduced in 2021. The code came about in response to the 2019 ACCC Digital Platforms Inquiry, which found that tech giants had substantial market power in the supply of internet search advertising services (Google) and supply of display advertising services in Australia (Facebook). These businesses make significant profits from users consuming content on their platforms, while the cost of creating this content is being borne by media companies. Their substantial market power has created an imbalance in bargaining power between the tech giants and news media businesses in Australia, and has made it unsustainable for media companies to invest in quality journalism, which is essential for a healthy democracy. Facebook fought against the regulation, initially blocking publishers and people in Australia from sharing local news content on its platforms. After a public backlash and last-minute changes to the regulations, agreements were reached for the digital platforms to pay more for the content that they were using on their sites to generate internet traffic and advertising revenue.

Australia has repealed many regulations that reduced competition, and most comparative studies conclude that Australia has a less regulated economy than most other advanced economies. Even so, many aspects of business activity are regulated. Environmental regulations play a significant role in the agricultural and mining industries. Construction, energy and transport have comprehensive safety regimes. Pricing and investment decisions are overseen by regulators in industries such as electricity, gas, water, postal services and telecommunications – as these industries are dominated by very large players that would otherwise have the ability to charge much higher prices because of the lack of outside competition. Professional services industries, such as law and accounting, exist in part to help businesses comply with and navigate regulation. When new areas of commerce emerge, such as ridesharing services offered by Uber, homesharing through Airbnb, online services through Google, Facebook and Amazon, and buy-now-pay-later credit products provided by Afterpay and others, governments have responded with new transport, safety, planning, privacy, tax, consumer protection and other laws.

Although Australia has undergone extensive deregulation, changes in technology and business models require ongoing changes to industry regulation. The coming years are likely to see new regulations for cryptocurrencies such as Bitcoin, and generative artificial intelligence products such as Open AI's ChatGPT. These products and services could bring harmful economic and social consequences without adequate market regulation. Two large sectors in the Australian economy that are already regulated but likely to undergo further significant reforms are the national market for disability services (facilitated by the National Disability Insurance Scheme or NDIS), and the national market for aged-care services. Demand for disability and aged-care services has grown rapidly, and determining the best model for service provision and regulation has proved difficult for successive governments.

## Reforms to public trading enterprises

Microeconomic policies have promoted efficiency in public trading enterprises (PTEs) – also known as government business enterprises – through two main approaches: **corporatisation** of PTEs and **privatisation** of PTEs.

### Corporatisation of PTEs

Corporatisation aims to encourage PTEs to operate independently from the government, as if they are private business enterprises. This involves eliminating political and bureaucratic supervision and making public enterprise managers accountable for enterprise performance. Corporatised public enterprises attempt to achieve a rate of return on assets comparable to private sector companies, and they often operate in competitive markets (although in some cases they continue to operate as regulated monopolies). In doing so, they must still comply with competitive neutrality laws that try to ensure that PTEs do not receive artificial competitive advantages over private businesses just because they are publicly owned. Examples of PTEs that have been subject to corporatisation are Australia Post, Energy Australia and the Sydney Water Corporation.

**Examples of privatised public trading enterprises are:**

Telstra, Qantas, GIO, Commonwealth Bank, NSW Ports, Queensland Rail, Victorian electricity, state banks and airports.

### Privatisation of PTEs

Privatisation takes corporatisation a step further by selling off PTEs so that they do in fact become private enterprises, either in whole or in part. Australia has undertaken extensive privatisation in recent decades, and the total value of privatised businesses is among the highest in the world. The most recent major privatisation by the Federal Government

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was health insurer Medibank Private, which after 38 years in government ownership was sold for $5.6 billion in 2014. In recent years, state governments have also privatised assets to free up capital for other purposes, such as transport projects. For example, the NSW Government's $20 billion privatisation of its electricity "poles and wires" business in the 2010s helped to fund several transport infrastructure projects, including a second harbour rail crossing, a light rail project and extension of Sydney's North West Rail Link. Governments have implemented privatisation with the aim of raising one-off revenues, increasing competition, encouraging more rational management and pricing behaviour, and forcing businesses to become more efficient.

In a departure from the trend of privatisation, in 2009 the Federal Government established a new public trading enterprise to build and operate an optical fibre telecommunications system, the National Broadband Network (NBN). The final cost of building the network was $51 billion. The NBN company is one of the largest in the Australian economy. It is expected to be privatised at some point in the future. Another example against the trend of privatisation came in 2023 when the new Minns Labor Government in NSW enacted legislation to prevent the future privatisation of two state-owned corporations, Sydney Water and Hunter Water.

**National Competition Policy** is an agreement between Australia's Commonwealth and State governments signed in 1995 to encourage microeconomic reform throughout the Australian economy.

## National Competition Policy

Competition policy aims to promote competition in markets so that firms increase efficiency and lower prices for consumers. Australia's laws regulating market behaviour went through a major shake-up after 1995 when the Commonwealth and state governments agreed to implement the **National Competition Policy**. Under these reforms, governments agreed to implement reforms that would increase competition in the sectors where they operated monopolies, such as electricity, gas, water, and rail and road transport. Governments also agreed to remove special provisions that gave publicly owned enterprises an advantage over private sector competitors (what is known as the "competitive neutrality" principle). The national competition watchdog, the **Australian Competition and Consumer Commission** (ACCC), was also established. The ACCC actively enforces Australia's competition laws, and, in 2022, its investigations of breaches of competition and consumer protection laws led to $230 million in penalties against offending businesses.

An important aspect of the reforms was the establishment of a national regime to regulate the cost of **access to infrastructure**. This meant that where businesses owned a monopoly infrastructure asset (such as owning an airport, rail line or telecommunications network), they were required to give competitors access to that network at a reasonable price.

A key principle of competition policy in Australia is **workable competition**. While governments generally aim to maximise competitive forces, workable competition may sometimes mean that in order to achieve international competitiveness, it may be necessary to reduce the number of firms in an industry. Those remaining firms can then operate on a larger scale and achieve the lowest possible long-run average costs of production.

A review of competition policy led by Professor Ian Harper (the Harper Review) in 2015 recommended that competition principles should be incorporated into a wider range of government regulations, procurement and service delivery systems, and extended to human services such as health and aged care. A Productivity Commission report concluded that with the public sector spending around $200 billion per year on human services, significant improvements in economic outcomes could be achieved by extending competition laws to social housing, public hospitals, services in remote Indigenous communities, and family and community services. The Harper Review concluded that implementing its reform could boost economic growth as much as the first round of competition policy reforms in the 1990s.

### BUSINESS PRACTICES OUTLAWED BY THE COMPETITION AND CONSUMER ACT INCLUDE:

- **Monopolisation**: when a firm uses its dominant market position to eliminate competition, such as through temporary price cutting.
- **Price discrimination**: when a firm sells the same type of good or service in different markets at different prices (for reasons not related to different costs, such as for transport).
- **Exclusive dealing**: when a firm sets conditions for supply that exclude retailers from dealing with other competitors.
- **Collusion and market sharing**: when firms get together to fix prices or agree on a market sharing arrangement that reduces effective competition between firms.

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While many of the Harper Report recommendations were not implemented, several changes were made to Australia's competition policy regime in 2017, principally by expanding the laws on misuse of market power. Businesses must not misuse their market power to reduce competition in the market by lowering prices, refusing to supply goods or services or other behaviours. Previously, regulators had to prove that a business actually intended to harm competitors in order to convict it of misusing market powers; under the new law, regulators now only have to establish that the business practice in question had the effect of harming competition. "Concerted practices" were also banned; they include actions such as sending price information to competitors, even if there is no formal agreement to collude to raise prices.

## Future of microeconomic policy

For more information on microeconomic policies, visit the following websites: **www.pc.gov.au** (Productivity Commission), **www.accc.gov.au** (Australian Competition and Consumer Commission).

Outline some areas the Productivity Commission has investigated for possible future microeconomic policies.

The period from the mid-1980s to the early 2000s witnessed extensive microeconomic reforms that saw industries change dramatically in Australia. Fewer reforms have been achieved in the past two decades, as the policy focus has shifted more towards macroeconomic concerns such as managing the mining boom, the global financial crisis, consolidating government debt and navigating the COVID-19 pandemic. In addition, implementing microeconomic reforms has become a much more difficult proposition for governments.

A key focus of the reform agenda in more recent years has been better coordination between the Commonwealth and state governments in areas where Australia's Constitution gives the states regulatory powers. Achieving agreement across all levels of government in Australia often proves difficult. For example, only limited progress was made with a set of "seamless national economy" reforms to simplify business regulations under the Rudd and Gillard Governments between 2007 and 2013.

Many other major recommendations made by policy reviews over the past decade have not been implemented. In 2020, the Morrison Government announced it would use the recovery phase following the COVID-19 pandemic as an opportunity to revisit long-standing economic reform opportunities, such as for taxation, industrial relations and business regulation. This included replacing the long-standing Council of Australian Governments (COAG) with a National Federation Reform Council (NFRC) that would be based on the success of the "National Cabinet" that brought the federal and state governments together in their response to COVID-19. This was celebrated at the time as a reform that would streamline and improve government decision-making. While some changes were achieved (for example, reforms to Australia's business insolvency laws introduced in 2021), little progress took place in difficult areas of recommended reform including in health care, schools, pharmacies and stamp duty on residential property.

In 2016, the Australian Government commissioned the Productivity Commission to publish a report every five years that assesses Australia's productivity performance and recommends productivity-enhancing microeconomic reforms. The first report, *Shifting the Dial*, was published in 2017. In 2023, the Productivity Commission published the second report in the series, *Advancing Prosperity*. It concluded that efforts to increase productivity should focus on Australia's services industries. Among its 71 specific recommendations are microeconomic reform initiatives in the following areas:

- harnessing data and digital technologies, such as providing better access to digital infrastructure (fast internet) in regional areas, and promoting the diffusion of new knowledge and data by, for example, making it easier to use intellectual property that provides significant value to society.
- education reforms, such as improving schools' capacity to provide foundational skills for Australia's future workforce (including digital skills), increasing access to and quality of tertiary education (university and TAFE) via regulation and price incentives, and supporting lifelong learning by workers to improve the adaptability of the workforce

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- economic dynamism reforms, including encouraging entrepreneurship, promoting investment in key areas by making land zoning more flexible, appropriately charging motorists for using roads, improving competitive pressures in highly regulated sectors (especially health services), and restructuring the tax system to make it productivity-enhancing.
- various climate change mitigation and adaptation reforms to improve Australia's future productivity performance
- non-market reforms such as making health services more integrated, patient-centred and data-driven, and increasing the allocative efficiency of public infrastructure funding.

The latest report also emphasised that the recommendations made by the first report, which focused primarily on health policies, how cities operate, and how state and federal governments work together, remain relevant and important.

## Overall impacts

Microeconomic policies have generally been championed by Australian governments because of their potential to lift economic growth and living standards. However, microeconomic reform has always been associated with shorter-term costs, such as job losses, business closures and damage to regional economies. As a result, many microeconomic reforms were met with strong opposition, especially from those sectors that stood to lose out from the changes. Microeconomic policies nevertheless have achieved extensive long-term benefits, which have become clearer over time.

Higher productivity growth from microeconomic policies has contributed to an **increase in economic output** and lower unemployment. According to the Productivity Commission, Australia's GDP was around 2.5 per cent, or $25 billion higher in 2005–06 as a result of Australia's extensive national competition policy reforms of the 1990s. This translated into **higher living standards** of around $1200 per person. These improved outcomes were the result of increased productivity growth as sectors of the economy became more competitive, innovative and flexible. The Productivity Commission has cited as evidence the pattern of higher productivity growth in sectors most affected by microeconomic reform in the years following implementation, such as telecommunications and financial services in the 1990s. More recently, the Productivity Commission has argued that Australia's poor productivity performance over the past decade highlights the need for more meaningful economic reforms. The Productivity Commission estimated in 2021 that, if productivity growth in the decade to 2020 had kept pace with the 60-year average (1.7 per cent compared to 1.1 per cent), gross national income per person would have been 6 per cent ($4600) higher in 2020.

"Although the past five years have been an eventful period for the Australian economy, the themes from *Shifting the Dial*, and the 28 recommendations from that report are, if anything, increasingly relevant following the significant COVID-19 disruptions of the past 2 years. However, overall, the dial has yet to be shifted by government. As noted by a number of submissions to this inquiry, although some progress has been made in terms of implementation, many recommendations, including those with potentially large economic implications, are yet to be implemented, and none have been fully implemented."

– *Productivity Commission* 5-year Productivity Inquiry: The Key to Prosperity – *Interim report no. 1 July 2022*

Australia has achieved weaker productivity growth since the mid-2000s, with especially weak growth in labour productivity (as distinct from the productivity of all combined factors of production). In the years leading up to the COVID-19 pandemic, productivity growth in Australia fell sharply to below the average rate in OECD countries. In a 2021 report, the IMF attributed this to a decline in productivity-enhancing investments (in areas such as R&D and information and communication technologies) and inadequate market competition in key industries. The Productivity Commission, IMF and OECD have all recommended that further reforms are needed if Australia is to return to the higher productivity growth required to generate higher living standards. In a 2021 review, the OECD recommended measures to strengthen competition and improve the operating environment for businesses, reduce Australia's reliance on tax revenue from income taxes towards more use of consumption taxes, and take steps to reduce inequality in educational attainment.

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A major benefit of microeconomic reform is **lower inflation**, resulting from greater competitive pressures and increased supply (both of which lower cost-push inflation) in sectors affected by microeconomic reforms. The Productivity Commission has estimated that since the early 1990s, rail freight rates have fallen by as much as 42 per cent, while both port and telecommunications charges have dropped by up to 50 per cent. Other Commission research has concluded that because of lower prices and higher wages, the benefits of microeconomic policies have been relatively evenly shared between individuals and businesses.

| BENEFITS |
| --- |
| Greater efficiency and productivity growth |
| New business and job opportunities |
| Higher economic growth and living standards |
| Lower inflation |
| **COSTS** |
| Higher unemployment in the short term |
| Closure of inefficient businesses |
| Greater work intensity |
| Less equal distribution of income |

Microeconomic policies are not without critics. Some argue that poorly designed reforms have simply replaced one problem with another. For example, the former chairperson of the ACCC, Rod Sims, in 2017 argued that privatisation was "severely damaging" the Australian economy because governments were selling vital assets such as ports and airports to private-sector monopolies, resulting in higher one-off revenues for governments but then large increases in prices to consumers. Another common criticism is that reforms have often benefited wealthy investors while costs have been borne unevenly by lower-income earners. Indeed, this is often cited as a criticism of policies introduced to encourage globalisation, such as reduced trade protection and barriers to foreign investment. Critics also question whether the productivity statistics exaggerate the benefit of microeconomic policies. For example, research has demonstrated that many workers are experiencing an increase in **work intensity** – that is, people working longer hours without extra pay. This means that some of the claimed increase in labour productivity may disguise the fact that people are now working longer hours than in previous decades but these extra work hours are not recorded. While microeconomic reforms are vital for generating increased productivity, growth and living standards, each reform needs to be evaluated on its own merits since not all reforms are effective. Designing and implementing microeconomic reforms is one of the greatest challenges for governments.

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### reviewquestions

1. Using ONE industry as an example, explain how microeconomic policies deliver better outcomes for consumers. Identify why businesses in this industry might resist microeconomic reform.
2. Summarise the microeconomic policies that have been implemented in individual sectors of the Australian economy.
3. Explain how microeconomic policies can lead to improved economic performance in the long term. Identify any costs of microeconomic policies.
4. Outline THREE areas for future microeconomic policies in Australia and explain how they might boost economic growth and productivity.

## 16.3 Environmental management policies

Environmental management policies are designed to address issues of environmental sustainability. These include the preservation of natural environments, pollution and climate change, and managing the use of renewable and non-renewable resources.

While environmental management policies often address different objectives than microeconomic policies, they are included in this chapter because, in many ways, they have a similar role in the economic policy mix. Like microeconomic policies, environmental policies aim to influence the long-term behaviour of households, businesses and industries. The two main policy tools for environmental management are regulations and market-

based policies to influence behaviour and reduce environmental impacts. Like other areas of economic policy, environmental management is guided by research bodies and by targets set by governments, and is influenced by international agreements between governments.

## Targets

The Australian Government uses many targets to guide its environmental policies. Australia's most important long-term policy target relates to the reduction of Australia's carbon emissions. This has proved to be the most difficult area of policymaking in the past two decades in Australia, with several Prime Ministers losing office after a backlash over their policies relating to energy prices and emission reductions. In 2022, the Albanese Government legislated two emissions targets: a 43 per cent reduction on 2005 levels by 2030, and a reduction to net zero emissions by 2050.

## Regulations

Environmental **regulations** are the traditional policy tool for achieving environmental sustainability goals. Regulations are laws or rules that govern economic behaviour. Regulations may prohibit a person from doing something that causes environmental damage, such as illegally dumping waste or producing polluting chemicals. Alternatively, regulations may specify how a good or service is produced or consumed, as with rules relating to agricultural or

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### THE GREAT BARRIER REEF

The Great Barrier Reef is the largest living structure in the world, covering 344,400 km$^2$ in area, with 3000 coral reefs, 1625 types of fish, 133 types of sharks and rays, over 200 types of birds and 600 types of coral. As the world's largest coral reef ecosystem, the Great Barrier Reef became a UNESCO World Heritage site in 1981 and is the most biodiverse heritage site, indicating its significant scientific and intrinsic importance. The Great Barrier Reef is also a major tourist destination, with over 2 million visitors each year, which contributes approximately $6.4 billion to the economy each year.

The Great Barrier Reef is suffering from the effects of climate change. Changes in ocean temperatures threaten the reef's delicate ecosystem. The latest five-yearly Great Barrier Reef Outlook Report downgraded the condition of the reef from "poor" to "very poor". In the previous five years, the reef experienced multiple episodes of coral bleaching as a result of marine heat waves, as well as cyclones and crown-of-thorns starfish. A recent aerial survey of the reef indicates that around two-thirds of the reef has now suffered from coral bleaching (around 1500 km of the total 2300 km length), and it would take many years to recover from the death of the coral, even without further water temperature rises.

In response to the recommendations for management and protection made in a monitoring report from the World Heritage Centre, the Queensland and Commonwealth Governments committed to a 2050 Long-Term Sustainability Plan, based on a two-year strategic assessment of the reef, and provided $140 million in funding. Its priorities include ecosystem health, biodiversity, heritage, water quality, community benefits, economic benefits and governance. Key elements include:

- establishing the $40 million Great Barrier Reef Trust
- banning the disposal of material from capital dredging projects within the Great Barrier Reef Marine Park, as well as restricting these activities to limited surrounding areas
- banning the disposal of material from capital dredging projects within the Great Barrier Reef Marine Park, as well as restricting these activities to limited surrounding areas
- providing additional protections for turtles and dugongs through anti-poaching laws, improved sustainability agreements and funding to reduce marine debris
- reversing the decline in water quality associated with agriculture, through $35 million in ongoing funding and an additional $100 million over five years to supportwater quality initiatives and scientific research and to transition current business practices
- reducing the presence of the crown-of-thorns starfish to support coral populations.

In 2022, the Albanese Government increased funding for the Reef 2050 Plan which supports marine ecosystem research and crown-of-thorns starfish culling programs, more sustainable farming and fishing practices, and protection efforts for turtles, dugongs and dolphins. Overall, the federal and Queensland Governments are jointly investing a total of $2 billion to protect the reef.

mining techniques. In Australia, environmental regulations can be made by local, state or federal governments, or by their agencies.

Some regulations impose requirements that the quality of goods meet environmental standards. For example, the Fuel Quality Standards Act 2000 regulates the quality of fuel for Australia. The aim of the legislation is to reduce the levels of pollutants and emissions from fuels that may cause environmental and health problems.

Regulation can require firms and individuals to follow certain environmental procedures. For example, the Environment Protection and Biodiversity Conservation (EPBC) Act provides a framework for the protection and management of matters of national environmental significance. This includes the protection of World and National Heritage sites, Commonwealth marine areas, nationally threatened species and ecological communities and migratory species. States and territories have responsibility for all other matters of state and local significance. In response to the 2021 five-yearly State of the Environment Report, which found a significant deterioration in many aspects of Australia's flora and fauna, the Australian Government is establishing a new national Environmental Protection Agency to strengthen monitoring and compliance with environmental regulations.

Broader regulatory frameworks can also relate to environmental issues. For example, investigations undertaken by the Australian Competition and Consumer Commission in 2023 published a report, *Greenwashing by Businesses in Australia*, that raised serious concerns about claims that businesses make about the environmental impact of their products and services. Of the 247 business examined, 57 per cent made claims that "raised concerns", including vague statements that lacked evidence or using third-party symbols or certifications in a confusing way.

## Market-based policies

Policies that create market-based incentives for environmental protection have been increasingly used in Australia and other economies during recent decades. Market-based policies involve financial incentives and disincentives (such as subsidies and taxes) to influence the behaviour of households and businesses.

As we saw in chapter 12, many environmental problems arise because of market failure. Environmental costs (or benefits), known as externalities, are borne by all of society and are not taken into account by producers and consumers in the marketplace. In the case of negative externalities, this results in the equilibrium price being too low and production being too high. Figure 16.3 shows the demand and supply for goods with negative environmental externalities.

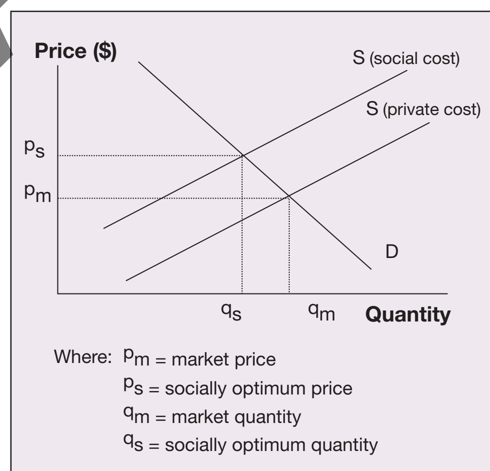


**Figure 16.3 –** Negative externalities

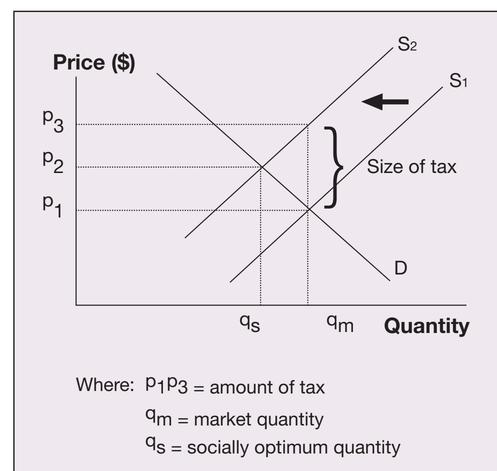


**Figure 16.4 –** Taxing the externality

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A market-based response to this scenario would be to levy a tax or fee on production that is approximately the same as the environmental costs associated with this economic activity. This should move the supply curve to the left, increasing the market price and reducing the amount consumed in the economy.

Figure 16.4 shows how a tax equal to the vertical distance between the curves shifts the supply curve from $S_1$ to $S_2$ and influences the market. This is sometimes called "internalising the externality" because it makes consumers and producers pay for environmental costs. Likewise, governments can provide subsidies to consumers or producers to encourage production of environmentally beneficial goods and services.

Governments generally prefer taxes over subsidies when they want to influence economic behaviour. Although it is difficult to calculate the full cost of an externality, and therefore to calculate the optimum tax rate to implement, there are other benefits to taxes over subsidies. Taxes discourage environmentally damaging activities. They also raise government revenue that can be used for other environmental programs. For example, through the Product Stewardship for Oil Program, the Government imposes a 8.5 cent per litre levy on the purchase of oil to help fund the recycling of old oil. Environmental tax revenues constitute a varying proportion of government tax revenues in OECD countries, ranging from less than 3 per cent in the United States to more than 11 per cent in India. Australia's revenues from environmental taxes are around 5 per cent of the total tax base.

Subsidies are grants provided by the government to producers with the aim of reducing costs of production and promoting environmentally beneficial activities. For example, the federal Government's Australian Renewable Energy Agency (ARENA) provides funding for research and development, as well as large-scale renewable energy projects.

Over time, there has been a shift towards policies to facilitate market development and support private sector investment, rather than more direct forms of government intervention. In 2023, the Australian Government introduced the Nature Repair Market Bill to Parliament. The Bill sets out a framework for a voluntary national nature repair market, which would issue tradeable certificates for projects that restore and protect nature. This rewards landowners for supporting biodiversity, and enables businesses to invest in nature repair.

Water management is another contested area of environmental policy that has adopted market-based reforms. A recent Productivity Commission review found that governments' water management efforts – which created clear property rights for water, established water markets and improved water planning – had been successful in lowering household water use, increasing water allocations to the environment, and making industry water use more efficient. However, the review also found that existing efforts were not sufficient to meet future water policy challenges associated with growth in city populations and the impact of climate change. It recommended changes to water management in urban areas, including water recycling and the use of stormwater. Water policy issues are also increasingly linked to an international climate change agenda. In 2023, the UN held its first international water conference in 46 years to grow commitments to improve management of water resources globally.

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## CLIMATE CHANGE POLICIES

"Decarbonising" economies – that is, reducing the carbon emissions from economic activity that contribute to climate change – is widely regarded by economists as the greatest economic reform challenge of the 2020s. Climate change poses a profound threat to the global economy, the stability of international relations and the environment. As the Reserve Bank noted in 2019, climate change threatens disruption to economic output through extreme weather events as well as higher insurance costs, legal risks and falling asset values. A 2023 IMF analysis of the effects of climate shocks on inflation and growth found that climate-induced natural disasters increase volatility, in particular inflation shocks, that can harm all sectors of the economy. Scientists are recording growing evidence of rising sea levels, more intense droughts and floods, and more extreme and unpredictable weather events. Despite widespread agreement on the seriousness of the threats from climate change, it has been very difficult for governments around the world to agree on how to respond and who should bear the costs of structural changes.

### International agreements

The global threat of climate change was recognised in December 1997 when 160 nations reached an agreement in Kyoto, Japan. The agreement limited emissions of carbon dioxide and other greenhouse gases. The Kyoto Protocol is an international agreement that required industrialised countries to set internationally binding emission reduction targets. At the 2015 UNFCCC Conference in Paris, representatives from nearly 200 countries made a commitment to keep "the increase in global average temperature to well below 2 degrees Celsius above pre-industrial levels". This is the benchmark scientists believe is necessary to prevent the most dangerous impacts of climate change. This agreement reflected the difficulty in climate change negotiations of achieving a compromise between the interests of high-income and developing countries. High-income countries have large per capita greenhouse gas emissions, whereas developing countries have lower but rising levels of emissions and rely on using cheap fossil fuels to expand their output and improve living standards. The Paris Agreement, effective since 2020, is significant because, for the first time, it included developing nations such as China and India, alongside the United States (which withdrew under President Trump, and then rejoined under President Biden). The Agreement has mechanisms for transparency and monitoring progress, but its weakness is that individual countries set their own targets for emissions reduction. The Paris Agreement came into force in November 2016, and has 193 signatories. Its implementation received a setback with the COVID-19 pandemic, with countries delaying negotiations for the "rulebook" to guide individual country actions.

### Setting targets for emission reductions

A key part of international policymaking to reduce global carbon emissions is that individual countries commit to achieving specific targets. Australia has in the past negotiated lower targets for emission reductions than most other advanced economies, arguing that our reliance on emissions-intensive industry and fossil fuels for energy has made it more expensive to achieve 'emissions abatement'. This is because the cost of reducing each unit of emissions in Australia is higher than in many other countries. Over time, this has resulted in growing global criticism of Australia's efforts to address climate change – particularly due to Australia's opposition to stronger action in international negotiations.

Australia's emission reduction targets have centred on three key dates:

- **2020 target:** In the lead up to 2020, Australia adopted a target of reducing carbon emissions by 5 per cent on 2000 levels. This target was criticised for being too low and while Australia met the target, it was only made possible due to a number of technical and temporary factors. These factors included a slower rate of growth than anticipated, the way that emissions relating to land usage were calculated and the success of the Renewable Energy Target which expired in 2020.
- **2030 target**: Australia's 2030 target was a major issue in the 2022 Federal election, with the Coalition parties (in government) committing to a 26–28 per cent reduction by 2030 on 2005 levels, while the Labor Party (in opposition) promised to increase this target to 43 per cent. Labor won the election, and along with a large number of Independent candidates (the "teal Independents") and Greens, advocated for a higher target. As a result, the 43 per cent target was subsequently passed into law in the Climate Change Act 2022. The Independents also successfully amended the law so that the 43 per cent target is a minimum, that climate policies benefit regional communities, and that advice is sought from the Climate Change Authority before setting future targets. The Climate Change Authority (CCA), an independent government agency, had in 2015 recommended a 40–60 per cent reduction by 2030.
- **2050 target:** Australia has committed to achieving "net zero" emissions by 2050. This requires a reduction of greenhouse gas emissions so that the amount of greenhouse gases that the Australian economy produces is the same as the amount we remove. In 2023, the Government also announced a new national government agency, known as the "Net Zero Authority", to support the energy transition required to achieve Australia's net zero target and manage the ongoing economic transformation.

Domestically, Australia's climate change policies have also faced criticisms from economists and business leaders about the absence of an overall policy framework to sustain long-term emission reductions since the abolition of the carbon tax in 2013. Since then, Australia's efforts have depended on piecemeal measures that have been

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criticised for relying too heavily on future technologies and for expensive one-off measures such as through the Emissions Reduction Fund. Other policy measures include the Renewable Energy Target, investments in low emissions technologies through the Australian Renewable Energy Agency (ARENA) and the Clean Energy Finance Corporation and the National Energy Productivity Plan.

### Market-based policies

Individual governments have implemented a range of market-based policies to meet emissions reductions targets. The most well-known example in Australia was the Gillard Government's carbon pricing scheme in 2012. It put a price on each tonne of carbon dioxide emitted as part of energy or industrial production processes. Adding a price factored the cost of carbon pollution into the cost of production, giving Australia's 500 largest polluters a financial incentive to switch to comparatively cheaper, lower-emissions processes. The carbon price was initially fixed and was due to be replaced by a "cap and trade" emissions trading scheme (ETS). In 2014, the Abbott Government abolished this scheme, arguing it was adding to business and household costs and damaging economic growth.

Emissions trading is used across the world, including in the EU, China and New Zealand. Under an ETS, businesses are issued permits, or need to buy permits, for the emissions of greenhouse gases. Such a scheme can be "internationally linked", meaning that businesses with excess emissions may buy permits internationally from businesses that produce fewer emissions and hold spare permits. This system of trading permits effectively puts a price on the emission of greenhouse gases and incorporates the real cost of carbon emissions into the price mechanism. It is a market-based mechanism to create incentives for businesses to develop new technologies and processes to reduce emissions. However, critics argue that acting ahead of other economies creates the risk of "carbon leakage" – where emissions-intensive industries simply move to countries with no emissions target, increasing domestic unemployment, but with no overall reduction in emissions.

The centrepiece of Australia's emissions reduction policy under the previous Coalition Government was the Emissions Reduction Fund, which replaced carbon pricing. Firms were paid out of this fund to reduce emissions from their production processes, at the lowest cost of abatement, a process overseen by the government's Clean Energy Regulator. The lowest-price emissions were purchased by the government via an auction where firms bid to sell their projects to reduce emissions at the lowest price. After 15 rounds of auctions, the Emissions Reduction Fund had purchased 217 million tonnes of $CO_2$ abatement. Uptake of the policy declined over time as low-cost opportunities for abatement were exhausted.

A second element of the scheme was the "safeguard mechanism" – a baseline level of emissions top polluters could not exceed or had to account for. This baseline and credit scheme is a market mechanism but not an emissions trading scheme. In 2023, the Albanese Government reformed the safeguard mechanism, with the goal of improving its effectiveness. From July 2023, top polluters across mining, manufacturing, transport, oil, gas and waste are required to gradually reduce emissions in line with Australia's emissions reduction targets. Firms must reduce their absolute emissions in line with a maximum annual cap that will decline over time.

> "In Australia we have put in place a number of arrangements to reduce emissions, including: regulation, subsidies, emissions trading schemes and baseline and credit schemes. The one thing they all have in common is that they all aim to provide an incentive to reduce emissions by changing relative prices …
>
> Policy making is difficult. Climate change is perhaps Australia's best recent example of how difficult it can be. It is especially difficult when many forces are arranged against the best outcome for the community …
>
> The more recent change of heart among business groups is because the world has moved in such a way that it is now in the financial interests of their members to no longer resist. Markets have begun to price in diminishing use of fossil fuels, banks and investors are baulking at, or charging a premium for, new fossil fuel investments, and most fundamentally renewable energy sources are now plainly cheaper than using coal or gas."
>
> *– Dr Steven Kennedy, Secretary to the Treasury, 20 July 2022, Speech to the University of Sydney – Celebrating 100 years of Economics*

### Regulations

Regulations also act to ensure that newly produced goods meet environmental standards that are consistent with Australia's aim to reduce greenhouse gas emissions. For example, in 2007 Australia banned older-style incandescent light bulbs, replacing them with more energy-efficient options such as fluorescent and LED bulbs. In 2010, planning laws in several states were changed to require newly constructed homes to comply with six-star energy ratings involving improved insulation, water recycling and other features. Government policy decisions around agriculture, mining and transport also have major effects on carbon emissions. As part of a broader package of climate change policies, the Albanese Government has committed to applying new standardised reporting requirements for climate risks and opportunities for large businesses.

State Governments are also acting to address climate change through regulatory measures. For example, the NSW Environmental Protection Agency released its first climate change policy and action plan, which signals stronger regulatory action to facilitate the state government's 2050 net zero commitment.

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## MURRAY-DARLING BASIN

Australia's Murray-Darling Basin is one of the world's largest river systems. It covers 14 per cent of the country, spanning from Queensland through NSW and Victoria to South Australia, and provides water for two million residents, industry and agriculture. But for decades, the government has faced challenges in managing the basin because of competing economic, social and environmental interests, and recurring water shortages.

By the beginning of the 21st century, conflicts between water users were taking a toll on the basin's health, and not enough water was reaching downstream users. The Murray-Darling Basin Authority was formed in 2007 to take responsibility for the basin. In 2010 it released the Murray-Darling Basin Plan, aiming to return up to 4000 gigalitres of water to the basin to improve the health of the river system. The plan was controversial, with claims that the plan could reduce agricultural production, increase unemployment, and threaten the viability of towns. Over the following decade, the implementation of the plan was plagued by controversy, including allegations of poor enforcement and corruption.

In August 2023, the Australian Government announced a new plan to balance the needs of the environment with the interests of different water users. It proposed to resume buying back water licences, a market scheme where water users such as farmers can voluntarily sell their licences to the government. Instead of drawing the water from the basin, the government 'uses' these licences to 'return' water to the environment, effectively reducing the amount of water that can be drawn from the basin to a more sustainable level. Queensland, NSW and South Australia signed on for the new plan but Victoria held off signing, due to concerns about the social and economic impacts of reduced water in agricultural communities.

## International agreements

For environmental management policies to be successful they often require international cooperation. Collective action is often necessary because individual nations cannot successfully address global environmental problems on their own. Additionally, when addressing environmental issues, individual nations are often reluctant to impose strict environmental management policies on their own economy if other nations are not willing to do the same.

One of the best-known global pollution problems is the **depletion of the ozone layer** (the atmospheric layer that filters out dangerous ultraviolet radiation). This is related to the emission of chlorofluorocarbons into the atmosphere from industry refrigeration units and aerosols. To reduce this problem, an international agreement known as the Montreal Protocol committed members to phasing out the production of ozone-depleting products by 2000. According to the United Nations Development Programme, over 98 per cent of ozone-depleting substances were eliminated between 1987 and 2014. As a result, scientists predict that the ozone layer should recover to pre-1980 levels between 2050 and 2065.

A number of other international environmental agreements are also in force. In many cases, international agreements are required to prevent the overuse of common international resources. This is an issue known as the **tragedy of the commons**. For example, the United Nations Fish Stocks Agreement, to which Australia is a signatory, was developed to ensure the long-term conservation and sustainable use of highly migratory fish stocks.

In 2023, an international agreement was reached for a new treaty to protect the seas and oceans outside country boundaries, which cover 60 per cent of the earth's surface. This agreement was supported by Australia and will establish Marine Protected Areas (MPAs) and processes for environmental impact assessments.

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| **Australia's participation in international treaties** | |
|---|---|
| **Treaty** | **Year signed** |
| The **CITIES Convention** on International Trade in Endangered Species of Wild Fauna and Flora | 1976 |
| The **Vienna Convention** for the Protection of the Ozone Layer | 1987 |
| The **Montreal Protocol** for Chlorofluorocarbon Control | 1989 |
| The **Convention on Biological Diversity** | 1993 |
| The **Convention to Combat Desertification**, to address land degradation in the world's drylands | 2000 |
| The **Stockholm Convention** for the protection of human health and the environment from organic pollutants | 2004 |
| The **Kyoto Protocol** on climate change | 2008 |
| The **Paris Agreement** on climate change | 2016 |

## reviewquestions

1. Outline the impact of international agreements on Australia's environmental management policies.
2. Explain the tools available to policymakers to achieve environmental sustainability.
3. Analyse the role of market-based environmental management policies in improving the economy's environmental sustainability.

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# chapter summary

1 **Microeconomic policy** is action taken by government to improve resource allocation between firms and industries, in order to maximise output from scarce resources and promote structural change. Microeconomic policy can help to accelerate the process of structural change by making the economy able to move factors of production from one area to another more quickly.

2 By reducing costs and increasing efficiency, microeconomic policies should have the effect of shifting the aggregate supply curve to the right so that more goods and services are produced at lower prices.

3 Since the 1980s, microeconomic policy has played an important role in the economic strategy of successive governments. Microeconomic policy is more effective than macroeconomic policy in addressing longer-term structural problems in the economy.

4 Microeconomic reform improves the efficiency of the operation of markets on the supply side of the economy. This results in an improvement in **allocative** efficiency, **technical** efficiency and **dynamic** efficiency.

5 **Deregulation** involves the removal of legislation and other rules that constrain the operation of market forces, and it aims to improve the efficiency of industries. In the past three decades, Australia has deregulated its financial services, telecommunications, electricity, gas, aviation and agricultural industries. This has had both positive and negative consequences.

6 Reforms to **public trading enterprises** have included **corporatisation**, putting the organisations at arm's length from government so they run like private sector businesses, and **privatisation**, which involves selling the business to the private sector.

7 **National Competition Policy** reforms introduced since 1995 have increased the level of competition across many sectors of the economy. The rules for business practices and prohibitions on anti-competitive behaviour are set out in the *Competition and Consumer Act 2010*, which is enforced by the Australian Competition and Consumer Commission.

8 Most economists agree that microeconomic policies have contributed to Australia's improved economic performance since the 1980s, with higher levels of productivity and economic growth and lower inflation and unemployment.

9 Environmental sustainability has been increasingly recognised as an important policy objective in the context of managing the economy. **Environmental management policies** such as targets, market-based policies and regulations aim to improve the environmental sustainability of the Australian economy.

10 The highest priority environmental issue is **climate change**, with economies across the world transitioning towards a "net zero" carbon emissions goal.

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# chapter review

1. Explain how microeconomic policies aim to increase economic growth.
2. Discuss how microeconomic policies contribute to greater efficiency in the economy.
3. With the aid of a diagram, explain how microeconomic policy influences aggregate supply in the economy.
4. Outline the main areas in which the government has implemented microeconomic policies.
5. Outline how and why the government regulates specific sectors of the economy.
6. Explain what is meant by deregulation. Using two specific examples, discuss the benefits of deregulating major industries.
7. Examine the benefits and costs of microeconomic policies.
8. Describe THREE environmental management policies that have been implemented in Australia.
9. Evaluate the effectiveness of regulations compared with market-based policies in achieving environmental sustainability.
10. Outline the influence of targets and international agreements on environmental management in Australia.

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# 17 Labour Market Policies

**17.1** Introduction
**17.2** The role of national and state workplace systems
**17.3** Australia's wage determination system
**17.4** Dispute resolution
**17.5** Decentralisation of the labour market
**17.6** Education, training and employment programs
**17.7** Evaluating labour market outcomes in Australia

## 17.1 Introduction

**Labour market policies** are microeconomic policies that are aimed at influencing the operation and outcomes in the labour market, including industrial relations policies that regulate the process of wage determination as well as training, education and job-placement programs to assist the unemployed.

**Labour market policy** involves governments influencing the process or outcomes of wage determination. Governments intervene in labour markets for several reasons, including:

- achieving **macroeconomic objectives such as low inflation** and macroeconomic stability (since wages growth is a major influence on inflation)
- achieving **microeconomic objectives such as productivity growth** and improved competitiveness for Australian businesses, and resolving disputes that arise in the workplace
- achieving objectives relating to the **distribution of income and wealth**, such as ensuring that fair minimum standards apply to all employees (since wages are the main source of income for most households).

In Australia, the Government has historically played an important role in wage determination, either directly or through independent industrial courts and tribunals. The extent of government regulation of the labour market has been a matter of ongoing debate since Federation in 1901.

## 17.2 The role of national and state workplace systems

Australia has traditionally regulated its labour market through a mix of federal and state laws, with significant overlaps between the different systems. This is because the Australian Constitution does not give the Commonwealth Government the power to directly legislate over the labour market – instead, it only gives the Commonwealth the power to resolve industrial disputes that cross state boundaries. Nevertheless, the Commonwealth has gradually expanded its role in labour market policies over the past century through other constitutional powers. These policies have centred on what have historically been called "industrial relations" or, more recently, "workplace relations".

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Over time, Australia developed separate **industrial relations systems** – six different state systems, plus the federal system. These systems established minimum wages and conditions for employees through a system of **industrial awards** for employees, based on their industry or occupation. Awards for some employees were made by the Commonwealth, while others were made at a state level. This meant that employers whose workforces spanned multiple states needed to comply with different state systems as well as the federal system.

The inefficiency of separate state and federal systems created pressure to adopt a national **workplace relations system**, resulting in the *Fair Work Act* (2009), which covers around 70 per cent of Australian workers. Figure 17.1 shows that the Federal Government's constitutional power extends to all employees of incorporated businesses and its own employees. State governments have also "referred" (that is, handed over) some of their powers to the Federal Government, including for employees of sole traders, local government and the state public sector. Western Australia is the only state that has not referred any powers to the Federal Government.

| | Corporations | Partnerships and sole traders | Local Government | State Government Public Sector | Federal Government Public Sector |
|---|---|---|---|---|---|
| NSW | ✔ | ✔ | ✘ | ✘ | ✔ |
| QLD | ✔ | ✔ | ✘ | ✘ | ✔ |
| SA | ✔ | ✔ | ✘ | ✘ | ✔ |
| VIC | ✔ | ✔ | ✔ | ✔ | ✔ |
| ACT | ✔ | ✔ | ✔ | ✔ | ✔ |
| NT | ✔ | ✔ | ✔ | ✔ | ✔ |
| TAS | ✔ | ✔ | ✔ | ✘ | ✔ |
| WA | ✔ | ✘ | ✘ | ✘ | ✔ |

**Figure 17.1** – Coverage of employees under the national workplace relations system

During this period, the Commonwealth also replaced most state-based awards with simpler federal awards, established a national system of occupational health and safety legislation, and set up the national workplace relations system. State and territory regulation of the labour market is now limited mostly to state government employees and to a smaller range of specific issues such as workers' compensation and public holidays. The national system is overseen by the Fair Work Commission (FWC).

## reviewquestions

1. Explain the role that national and state systems have traditionally played in the regulation of the Australian labour market.
2. Outline the benefits of shifting towards a national workplace relations system.

SAMPLE PAGES

# 17.3 Australia's wage determination system

Australia's national wage determination system is set out in the *Fair Work Act* (2009), and it covers around 70 per cent of working Australians. There are four means for determining pay and conditions for employees within this national system:

- **Awards** and **collective agreements** (or enterprise agreements) make up the formal system.
- **Individual contracts** (sometimes called common law contracts) and **working business owners** form the informal system.

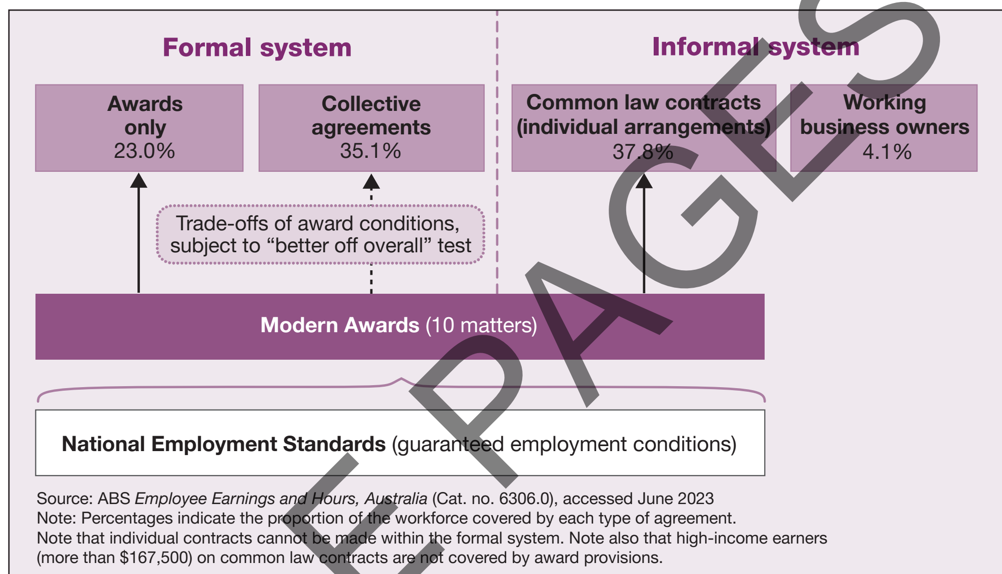


**Figure 17.2 –** The workplace relations framework

For a detailed overview of Australia's wage determination system, visit the Productivity Commission's website and download the Workplace Relations Framework report from 2015: **www.pc.gov.au/inquiries/completed/workplace-relations/report**

Around 30 per cent of Australian workers are outside the national wage determination system, in two main groups:

- individuals whose conditions are unregulated (17 per cent of Australian workers), divided evenly between independent contractors and other business operators
- individuals regulated by a state workplace relations system (12 per cent), almost all of whom are state public sector employees.

Below, some key features of the national workplace relations system are examined.

## Minimum employment standards

Australian employees are protected by a set of legally guaranteed employment conditions, known as the **National Employment Standards (NES)**. These provisions include:

- *Maximum weekly hours of work.* A full-time employee's hours of work must not exceed 38 ordinary hours per week, plus reasonable additional hours of work.
- *Right to request flexible working arrangements.* Parents or carers and people over 55 years of age or living with a disability may request a change in working arrangements, such as changes to hours, job sharing and working from home. Employers can only refuse on "reasonable business grounds".
- *Leave.* Employees have the right to paid annual, sick and compassionate leave as well as public holidays. They further have the right to unpaid parental, community service and long service leave.

SAMPLE PAGES

- *Casual conversion.* Casual employees who have worked for their employer (excluding small business) for more than 12 months must be offered the option to convert to full-time or part-time employment.

In 2023, the Albanese Government introduced legislation to expand the NES to include provisions relating to superannuation (the Superannuation Guarantee and protection from underpayments) and up to 10 days' paid leave for victims of domestic violence. These were described as the most significant changes to the NES since the *Fair Work Act* came into operation.

## Minimum wages

The **national minimum wage** provides a safety net for any employee not covered by an award. The Fair Work Commission Expert Panel conducts an Annual Wage Review to set minimum wages (and award wages), which take effect from 1 July each year. The *Fair Work Act* requires the panel to consider both economic and social objectives when determining the minimum wage. This includes the performance of the national economy, the macroeconomic impact of its decision, the impacts on businesses (who might be discouraged from hiring additional employees) and the cost of living for households.

> "Inflation is reducing the real value of these employees' incomes and causing households financial stress. We have also taken into account the recent robustness of the labour market, and the fact that increases to modern award minimum wage rates will provide a disproportionate benefit to female workers and may contribute to narrowing the aggregate gender pay gap across the entire employee workforce."
>
> *– Fair Work Commission Annual Wage Review Decision 2023*
> *2 June 2023*

In June 2023, the Fair Work Commission announced a two-tiered increase to wages in Australia. The national minimum wage was increased by 8.6 per cent, from $21.38 per hour to $23.23 per hour, or $882.80 per week. Other award pay rates were increased by a slightly lower amount of 5.75 per cent, with a guaranteed minimum increase of $40 per week.

This decision delivered the highest minimum wage increase since Australia's centralised wage system was established in the early 1980s. This was a response to inflation rising to 7.8 per cent in the March quarter of 2023.

### COVID-19 AND THE LABOUR MARKET

Australia's wage determination system was designed to provide flexibility in response to the ups and downs of the economic cycle. However, the labour market impacts of the COVID-19 pandemic in 2020 were so unprecedented that temporary changes to the system were taken to minimise job losses during the national lockdown, which closed many places of work – with the support of governments, businesses and unions.

A lesson from past recessions is the long period of time it takes to reduce sudden increases in unemployment. To prevent employers laying off workers, the Government introduced JobKeeper, a payment to businesses initially set at $1500 per fortnight to subsidise employee wages.

In addition to the JobKeeper program, agreement was reached between governments, employer groups and the Australian Council of Trade Unions (ACTU) to allow temporary changes to the *Fair Work Act*. Rules relating to workers' hours, duties, days and location were suspended for a period of six months, giving employers powers to change existing arrangements quickly and to require employees to use up their annual leave. This was significant as it not only made the workforce vastly more flexible during lockdowns, but also because it remains one of very few instances in which unions and business groups have found consensus on wage determination.

While there was agreement between the Government, employers and unions on these emergency measures, there was no consensus on longer-term reform. The Morrison Government nevertheless tried to make several changes to the *Fair Work Act*, but only secured enough votes in the Senate for some small changes to improve protections for casual employees.

SAMPLE PAGES

**Awards** establish the minimum wage and working conditions for employees based on their industry.

## Awards

**Awards** are a set of pay and conditions that are specific to an employee's work or industry sector (such as the Airport Employees Award or the Gas Industry Award). Awards provide a safety net of minimum wages and conditions. Many employers pay above award wage rates, but awards set the minimum rates of pay and entitlements. The Fair Work Commission sets these minimum award wage rates.

In the past, awards were complex and comprehensive, sometimes relating to specific firms. Under the *Fair Work Act*, Australia's award system was restructured and streamlined from around 4300 awards to 123 awards (although some state awards continue to operate). These consolidated awards are sometimes known as **modern awards**. In the retail sector, one of Australia's largest industries, the *Fair Work Act* replaced 41 federal and state awards totalling 2082 pages with just two awards totalling 76 pages.

Figure 17.3 shows that awards are an important part of the workplace relations system. The number of employees covered by awards has grown in the past decade, reflecting the fact that modern awards are often simpler for employers to use than negotiating enterprise or individual agreements. One study estimated that a further one in five non-award employees are employed on "over-award" arrangements – where awards form the basis of individual or collective agreements, but those agreements add to the award conditions. This suggests that in total, around 40 per cent of employees are on "award-based" arrangements.

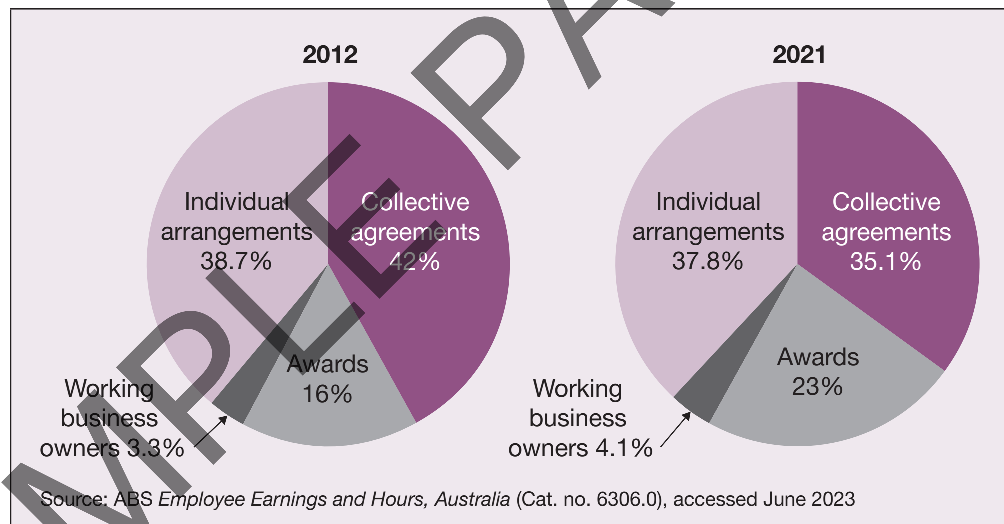


**Figure 17.3 –** The national wage determination system, by types of employment contract

SAMPLE PAGES

Modern awards extend the protections of the National Employment Standards, with provisions tailored to the needs of a specific industry, occupation or enterprise. These may include types of employment, arrangements for when work is performed, overtime and penalty rates, annualised wage or salary arrangements, allowances, leave-related matters, superannuation and procedures for consultation, representation and dispute settlement.

Further, modern awards (as well as enterprise agreements) must now include a clause that allows for an **individual flexibility agreement (IFA)**. This clause enables an individual employee and employer to vary the effect of an award to meet their needs without negotiating a separate agreement. The flexibility clause can only vary specific terms, such as when work is performed, overtime rates, penalty rates and leave loading. The IFA must leave the employee better off overall. Flexibility clauses can only be made after the employee has commenced employment and cannot be offered as a condition of employment. Flexibility clauses allow work arrangements to reflect the particular needs of firms and individuals, while preventing employers from using flexibility arrangements to reduce pay and conditions. Research by the Fair Work Commission in 2021 found that IFA usage is very low, but temporarily increased during the pandemic.

## Enterprise agreements

The most common method of wage determination in the formal system is a workplace agreement negotiated collectively between an employer (or employers) and employees, usually represented by unions. These are known as **enterprise agreements** (known elsewhere as collective agreements). The *Fair Work Act* introduced a right for employees to engage in **enterprise bargaining** with employers. Employers can be required to engage in bargaining discussions if a majority of employees vote in favour of seeking a collective agreement. As figure 17.3 shows, 35 per cent of employees in the national system are covered by enterprise agreements (down from 42 per cent in 2012), which is above the average of 32 per cent coverage across OECD economies.

**Enterprise agreement** is a collective workplace agreement that is negotiated between an employer and a group of employees, usually through a union.

As a minimum, all agreements must comply with the National Employment Standards and cannot offer pay rates below the equivalent award. Enterprise agreements must also pass the **"better off overall test" (BOOT)**, requiring employees be made better off overall under the agreement compared to the applicable award. The BOOT also applies to any individual flexibility agreement, a clause that can be negotiated as part of an enterprise agreement. The Fair Work Commission administers the test.

Enterprise agreements usually cover all workers up to management level in a workplace. Unions usually negotiate these agreements on behalf of all employees in a workplace, even though only 12.5 per cent of Australian workers are union members. Collective agreements normally cover issues such as wage increases, loadings for additional work hours, and other changes that are intended to increase productivity. Wage increases under collective agreements declined from an average of around 4 per cent (from 1991 to 2015) to 2.7 per cent between 2015 and 2022. Changes that came into effect from 2023 have made it easier for employees to negotiate multi-employer enterprise agreements, especially in sectors that have had low levels of collective agreements. These changes also gave the Fair Work Commission greater powers to determine outcomes (known as arbitration) where disputes have become "intractable" (that is, there is no prospect of reaching an agreement).

## Common law contracts and employment contracts for high-income earners

Individual arrangements cover almost 40 per cent of workers in the federal system. The most common individual arrangement is a **common law contract**, which are especially widespread in small businesses. These often set out terms of employment in just one or two pages. These arrangements are enforced through ordinary law courts rather than through workplace tribunals, as they are not considered to be part of the formal industrial relations system.

**Common law contract** is an individual agreement between an employer and individual employee that sets out pay and conditions for work. These are commonly used by small businesses and high-income earners not covered by awards.

There are two key differences between common law contracts and enterprise agreements. The first is that they are negotiated individually, not collectively. The second is that they cannot trade off or lower any award entitlements inlcuding pay. The one exception to this rule is **employment contracts for high-income earners**. Under the *Fair Work Act*, modern awards do not apply where an employee is earning in excess of a threshold (salary of $167,500 in 2023–24). High-income earners are only covered by the National Employment Standards rather than entitlements in awards as the award system was designed to provide a safety net for lower-income workers with less protections.

Except for high-income earners, individual contracts cannot bypass the award system and industrial regulations. Previously, a system of individual contracts known as Australian Workplace Agreements (AWAs) were allowed from 1997 to 2009. They were abolished by the *Fair Work Act*, following criticism that they were unfair because employers have much greater bargaining power than individual employees, so AWAs were often imposed on employees with no genuine negotiation process. In some cases, employers used Australian Workplace Agreements to remove entitlements that employees had previously enjoyed under collective (or enterprise) agreements and awards, such as penalty and overtime rates.

SAMPLE PAGES

## EMPLOYEES OR INDEPENDENT CONTRACTORS? THE DILEMMA OF WORK IN THE "GIG ECONOMY"

One of the greatest challenges to Australia's labour market policies today is the transformation of work arising from the "sharing economy" or the "gig economy". Sharing economy businesses provide a platform for customers to interact directly with individual workers who provide services such as fast-food delivery, transport and general household assistance. A report commissioned by the Victorian Government estimated in 2020 that more than one million Australians had gig economy jobs, with over 100 digital platforms.

Gig economy businesses usually classify their workers as individual contractors rather than as employees. However, gig economy businesses often treat workers like employees, providing the materials needed for the job and setting a fixed rate of pay per item contractors produce or service they perform (such as delivery of fast food). This lowers business costs compared to hiring employees, because those businesses are able to avoid normal employee entitlements and award wages.

During the 2010s, the FWC made several major rulings for gig economy employment using what is known as the "multi factor test" (see figure 17.4), which considers the key factors of an individual's day-to-day work. However, a landmark High Court decision in 2022 ruled that a written contract ultimately determines whether an individual is an employee or contractor. The Fair Work Commission then followed that ruling and found that a Deliveroo driver was not protected from unfair dismissal, because he was not an employee under the terms of his contract. As a contractor, he had no protections when he lost his job with Deliveroo in 2020 after its algorithm determined he was too slow in his deliveries. In contrast in 2022, a NSW court ruled that a Hungry Panda delivery rider who died in a road accident while making a delivery was in fact an employee. His family was therefore entitled to an $830,000 workers' compensation payout.

To resolve this confusion, the Albanese Government set out plans to give the Fair Work Commission (FWC) formal powers to establish minimum standards for gig workers, while aiming to preserve the flexibility of digital platforms. The Closing the Loopholes Bill, introduced to parliament in September 2023, also addresses loopholes relating to "permanent casuals" and under labour hire arrangements. The gig worker protections apply to individuals who are not employees but are doing "employee-like" work via a digital platform. The FWC is given powers to create minimum standards where three conditions are met: individuals are on low pay compared to employees, have low bargaining power, and have limited control over their work. In introducing the Bill, Workplace Relations Minister Tony Burke argued that, "it's got to be possible to have 21st-century technology without having 19th-century working conditions".

SAMPLE PAGES

| | EMPLOYEE | INDIVIDUAL CONTRACTOR |
|---|---|---|
| Control over how work is performed | Less control | More control |
| Hours of work | Standard or set hours | Controls hours of work |
| Bears financial risk | No risk | Bears the risk of making a financial loss on each task |
| Superannuation | Employers pay | Pays themself |
| Entitled to receive paid leave | Yes | No |
| Expectation of work | Ongoing expectation | Engaged only for specific tasks |
| Tools and equipment | Provided by employer | Uses their own |

Source: Fair Work Ombudsman

**Figure 17.4 –** How the FWC distinguishes employees from independent contractors

## reviewquestions

1. Identify the THREE main ways in which the wages and conditions of Australia's employees are determined.
2. Describe how minimum wages and conditions are determined.
3. Explain the difference between an enterprise agreement and an individual agreement.
4. Explain how an employer can make an individual agreement with an employee.

# 17.4 Dispute resolution

One of the most important roles of an industrial relations system – alongside determining wages and work practices – is to resolve disputes that arise between employers and employees (commonly described as the "parties" to an agreement). Disputes can arise because of disagreements over many issues, including changes to wages, work conditions, business restructuring and specific actions of employers that employees consider wrong or unfair, such as a decision to sack an employee or some employees. Disputes can lead to different forms of industrial action that interrupt work, including:

- strikes, in which employees withdraw their labour and refuse to work
- work bans, in which employees refuse to undertake a certain aspect of their work
- lockouts, in which employers refuse to give employees access to their workplace.

An **industrial dispute** occurs when employers or employees take action to disrupt the production process in order to highlight a disagreement between employers and employees.

One of the aims of an industrial relations system is to solve these disputes quickly, efficiently and fairly, because industrial action can result in reduced productivity, lower output, lower profits and damage to a business's customer relationships.

The processes for resolving industrial disputes in Australia have undergone major change in recent decades. Since the early 20th century, Australia has mostly relied on a unique system of specialist industrial tribunals to administer dispute resolution processes. The specialist tribunals aim to avoid drawn-out disputes that occur in other countries and allow for an independent umpire to make a judgment based on fairness and business conditions. The two main forms of dispute resolution that have been practiced in Australia are:

- **Conciliation** – a process whereby an industrial tribunal tries to help the parties reach a mutual agreement. The tribunal does not impose a resolution on the parties, but once the parties reach an agreement, they might undertake proceedings with the tribunal to formally implement their respective sides of the agreement.
- **Arbitration** – when an industrial tribunal makes a legally binding ruling that resolves a dispute. This occurs after the tribunal has given both parties the opportunity to put forward their arguments. Where conciliation is unsuccessful, arbitration can resolve the dispute and require employees to return to work.

**Conciliation** is a dispute resolution process in which firms and employees meet to discuss their differences in the presence of a third party (such as from an industrial tribunal) who attempts to bring the parties to an agreement.

**Arbitration** is a dispute resolution process in which an industrial tribunal hands down a legally binding ruling to firms and employees.

Australia has shifted from resolving industrial disputes mainly through compulsory arbitration to a system where arbitration is only used in rare circumstances. In most instances, employers and employees take responsibility for resolving their disputes. Under the *Fair Work Act*, the Fair Work Commission has limited powers to intervene:

- **Compulsory dispute settlement terms:** The *Fair Work Act* requires that all awards and enterprise agreements explain the process that the parties will adopt if they have a dispute relating to their agreement. A common feature of such a term is that if parties cannot resolve a dispute between themselves, they must refer it to a third party organisation that can assist. This third party might be the Fair Work Commission or a non-government organisation that offers dispute resolution services.
- **Bargaining in good faith:** To make the bargaining process fair and orderly, both employers and employees must comply with six good faith obligations, including participating in all meetings, disclosing relevant information, giving genuine consideration to all proposals and refraining from conduct that would undermine collective bargaining. Although it rarely uses these powers, the Fair Work Commission can make legally binding orders if either side breaches their obligation to bargain in good faith. The aim of the bargaining rules is to put pressure on both parties in a negotiation to be constructive and reach agreement.
- **Intractable bargaining declarations**: Under changes in effect from 2023, the Fair Work Commission can make a declaration where negotations have become "intractable", and after an optional period of time for parties to finalise negotiations, the Commission can decide the outcome of the negotiations, through a workplace determination.

SAMPLE PAGES

- **Resolving industrial action:** Industrial action is permitted during the process of enterprise bargaining. The Fair Work Commission is only able to step in to suspend or terminate such industrial action if special circumstances exist, including where there is threat of significant harm to the economy or the population, or the industrial action has been going on for a long period of time and is damaging the bargaining parties.

One measure of the effectiveness of an industrial relations system and its dispute resolution processes is the level of disputes and strikes. As figure 17.5 shows, Australia has experienced a low level of days lost in industrial disputes in recent years (in contrast, more than 4 million days' work were lost due to disputes in 1981). The low level of industrial disputes reflects the way in which employer/employee relations changed in recent decades, with increased competitive pressures, changes in industry structures and lower levels of union membership. There is now less conflict and a stronger focus on employers and employees cooperating to resolve disputes themselves. In addition, since the 1990s the right to strike has been curtailed by laws that only allow industrial action during a formal bargaining process and only in very limited circumstances when an enterprise agreement is in force. Nevertheless, the Productivity Commission has previously noted that industrial disputes play a positive role in reducing workplace power imbalances and can improve efficiency in the long term.

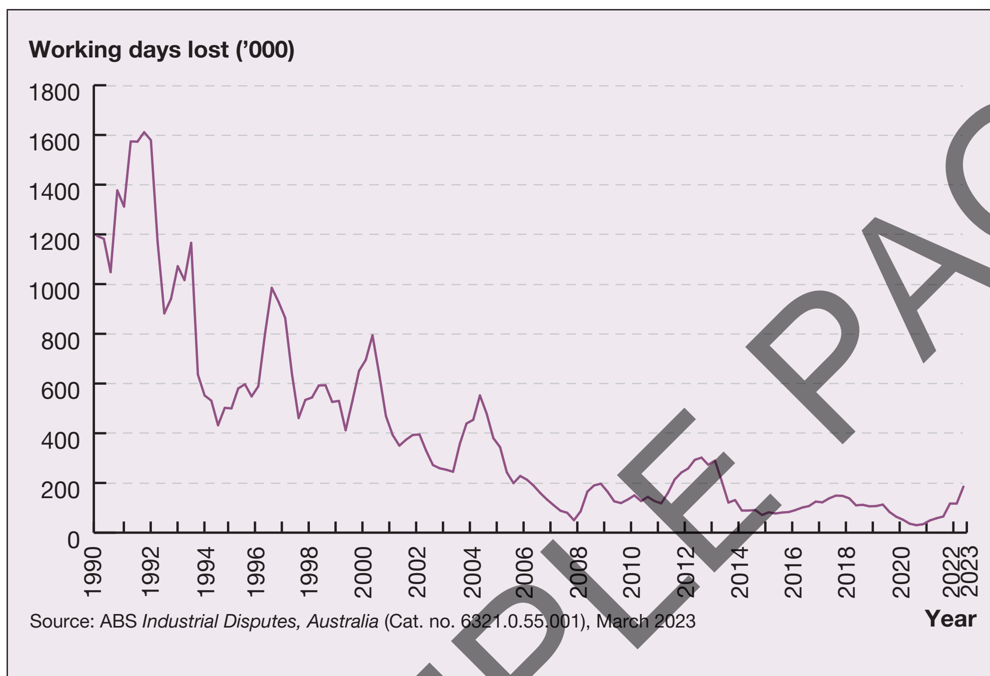


**Figure 17.5 –** Number of working days lost due to industrial disputes in Australia, 1990–2023

SAMPLE PAGES

## WHERE DOES THE GENDER PAY GAP COME FROM?

One aspect of Australia's industrial relations system that has recently been tested through industrial action is the pay gap between men and women. This is known as the gender pay gap. The pay gap is monitored by the Workplace Gender Equality Agency.

The national gender pay gap fell to a record low of 13.3 per cent in 2023. It has fallen significantly since 2014, when women earned, on average, 18.5 per cent less than men. One reason for this gap is that male-dominated industries, such as mining and financial services, tend to pay more than industries with higher proportions of female workers, such as health and education (the gender pay gap is 22.1 per cent in Western Australia, which has a higher proportion of mining and construction industry jobs, whereas it is only 7.8 per cent in South Australia). The gap is also higher in the private sector (16.1 per cent) than the public sector (11.2 per cent), and higher for those on individual agreements (16.1 per cent) compared to collective agreements (12.8 per cent).

Not every comparative measure shows women being paid less than men. Among employees who are directly covered by awards, pay for women is 3.8 per cent higher than for men. Award-only pay is more common in industries with higher female employment, reflected in the fact that women are the majority of the 23 per cent of employees who are on award-only pay arrangements (comprised of 13.6 per cent women, 9.4 per cent men). But since award-only employees are typically paid less than those on enterprise agreements or common law contracts, in overall terms the gender pay gap is not bridged by the award system.

## review**questions**

1. Describe TWO ways in which disputes between employers and employees might be solved.
2. Explain how the role of industrial tribunals in dispute resolution has changed in recent years.

## 17.5 Decentralisation of the labour market

Australia's industrial relations system has undergone a historic shift in recent decades from a highly centralised wage determination system for most of the 20th century, to a system where wages are mostly determined through enterprise bargaining at the level of individual businesses or workplaces. This reflects a shift from using **non-market forces** to a greater reliance on **market forces** to determine wage outcomes.

A **centralised** labour market is one in which wages and other labour market outcomes are primarily determined by a government, or a government-appointed tribunal such as the Fair Work Commission. A **decentralised** labour market determines wage outcomes at a workplace level, with a lesser role for industrial tribunals. This means that market forces of supply and demand for labour, as well as the individual firm's capacity to pay, play a greater role in determining wage increases. This ensures that there is more flexibility, and wage levels change between different firms and industries.

Early in the 20th century, Australia developed a centralised system of wage determination that reflected a national culture of fairness and a belief that workers should be paid the same wage for doing the same work. It also reflected the influence of the union movement, with most Australian workers belonging to a union. The national industrial tribunal was known from 1904 to 1956 as the Commonwealth Court of Conciliation and Arbitration (now the Fair Work Commission), and similar tribunals also existed at a state level. Governments believed that allowing the market to set wage levels would result in some workers being underpaid and exploited. Instead, a system of tribunals could deliver fairer and more consistent outcomes, using a formal process in which representatives of employers and unions presented their arguments for or against a wage increase or a change in working conditions.

In the early 1990s, economists argued that greater flexibility was needed so that wages could increase faster in more efficient sectors (to attract more labour), and wage increases needed to be more closely tied to productivity growth so that employees had the incentive to improve their skills and work practices. As a result, from 1991 Australia began shifting to a labour market where wages were mostly set through enterprise bargaining, while the highly centralised award system would only provide a safety net of minimum wages and conditions.

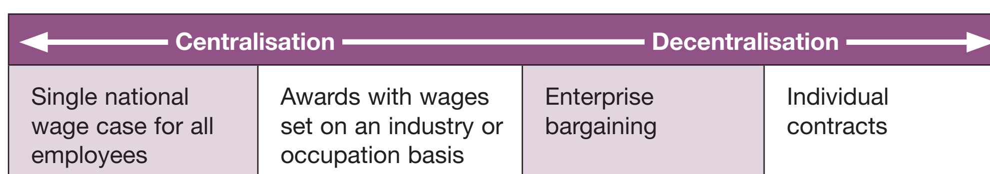


**Figure 17.6** – Centralised and decentralised wage determination systems

SAMPLE PAGES

## Arguments in favour of decentralisation

- A decentralised system can lead to a more **efficient allocation of resources** and structural change. Firms that are more efficient can afford to pay more and therefore attract higher-skilled employees. In contrast, centralisation can slow down the pace of structural change. If the same wage increases occur across all industries, it becomes difficult for more profitable and growing industries to attract more highly skilled labour from less profitable and declining industries – therefore slowing down the process of structural change in the economy. The decentralised labour market made it easier for Australia's mining industry to attract skilled labour from other sectors of the economy by offering higher pay. Between 2005 and 2015, the Wage Price Index for mining industry workers grew by 53 per cent, compared to an average of 40 per cent for workers generally.
- A decentralised system can promote **productivity**. It gives employees the incentive to work more efficiently, because they can be rewarded directly for their productivity improvements through arrangements at the workplace level. Conversely, under a centralised wage determination system, employees in individual workplaces may not have enough incentive to implement productivity improvements if they are already guaranteed a uniform wage increase, regardless of whether or not they improve their skills or adopt more efficient work practices. Higher productivity also helps to reduce **inflationary pressures** in the economy.
- Wage flexibility can help the labour market adjust when the economy is affected by negative shocks, which helps keep **unemployment** at a lower rate. If a recession causes a reduction in the aggregate demand for goods and services, therefore decreasing the demand for labour, a flexible labour market can allow wages to fall while keeping people in jobs. This might help to minimise job losses or reductions in corporate profits during a downturn. For example, during the COVID-19 pandemic, some firms initially reduced the working hours of full-time employees as a trade off for eliminating fewer jobs. As the economy recovered, staff returned to full-time roles.

## Arguments against decentralisation

- Decentralisation tends to lead to greater **inequality** through increased "wage dispersion". Workers doing the same job in different industries or firms may receive different pay and working conditions. This is particularly the case for low-skilled workers, who are easier to replace, might be less familiar with their workplace entitlements and are less able to demand pay rises from their employers.
- A decentralised labour market can produce **outcomes that reflect imbalances in bargaining power** between employers and employees. Those employees who are in an industry or firm where unions have little power are less likely to achieve wage increases, regardless of their productivity, because they lack bargaining power with employers. In practice, wage increases can often reflect the bargaining power of employees more than improvements in productivity. In 2023, the Government enacted "multi-employer" bargaining to give employees more bargaining power.
- **Enforcement of wage entitlements** becomes more difficult under a decentralised system. In recent years, widespread problems with the underpayment of workers have emerged across many Australian industries. In 2023, Fair Work Australia secured undertakings to redress underpayments from a wide range of small to large businesses, including $32 million from Suncorp and $4 million from the University of Technology, Sydney. Even the Reserve Bank owned up in 2023 to over $1 million of underpayments. In 2023, the Government announced plans to strengthen enforcement for wage entitlements through introducing criminal penalties and requiring employers to pay superannuation at the same time as ordinary wages to prevent long-term underpayments of superannuation.

SAMPLE PAGES

- Centralised wage determination can provide an **additional policy tool** for the government to influence labour market outcomes and achieve economic policy goals such as lowering inflation. For example, it could restrain wages growth to avoid cost-push inflation, or trade-off a tax cut in exchange for lower wage increases. While economists generally favour more flexible and decentralised wage determination systems, as the *OECD Employment Outlook* highlighted in 2019, some degree of centralisation allows governments to target labour market policies more effectively, including retraining, improving skills, adopting new technology and protecting employee rights.

### reviewquestions

1 Explain the difference between a centralised and decentralised industrial relations system.

2 Discuss the advantages and disadvantages of centralised and decentralised wage determination systems.

## 17.6 Education, training and employment programs

In addition to regulating the industrial relations system, governments also influence labour market outcomes through their policies relating to education and training, apprenticeships, social security (welfare benefits) and employment services. These policies aim to increase participation in the workforce, improve the productivity of the workforce and prepare workers for future changes in the labour market. Labour market policies can use a wide range of policy instruments to achieve these outcomes.

### Education and training

Governments play a central role in shaping the education system, ranging from pre-school to tertiary education. From an economic perspective the most successful education system is one that provides students with a broad range of skills that will help make them more productive and able to adjust to changing economic conditions. Overall, the economy will be more productive and grow faster if it has a higher quality and more responsive education and training system.

To improve Australia's capacity to train workers for the skills demanded by a fast-changing job market, in 2022 the Albanese Government established Jobs and Skills Australia. Its role is to improve Australia's long-term planning of skills training, addressing significant national skill shortages and helping workers re-train for jobs in growing sectors. According to the Labour Market Update in May 2023, 92 per cent of new jobs in Australia require post-secondary school qualifications. Increased use of artificial intelligence is accelerating change in the labour market, underscoring the need for ongoing training for workers to have the skills required by the labour market.

To encourage school leavers to study in areas where there are shortages of workers, in 2022 the Morrison Government significantly changed the prices of university degrees. Fees decreased up to 60 per cent for health, maths, agriculture and teaching degrees to encourage high school leavers to study (and ultimately work) in these areas facing shortages. In contrast, in other areas such as humanities and communications, fees increased by 113 per cent. However, data from NSW universities showed that despite the higher fees, there was a 9 per cent increase in enrolments for humanities degrees in 2022. This reflects the fact that fees are only one of several factors, along with interests, abilities and earning potential, that shape student choices.

SAMPLE PAGES

Several recent education and training programs and reforms have aimed to improve workforce skills, increase job growth and raise productivity:

- The National Cabinet (which brings together Federal, State and Territory governments) agreed on a National Skills Agreement in 2022, which included funding for 300,000 additional fee-free TAFE and vocational education places.
- In 2023, the Government announced a partnership with universities to offer 28 "micro-credential" short courses to fill key skills gaps in the Australian labour market. The courses include teaching, nursing, engineering and cyber security. To encourage uptake of these courses, individuals can access the same scheme to defer payment for their course as standard university degrees.
- Early childhood education standards have been increased and places have been expanded to provide access for all children before starting school.

## Labour market programs

Governments deliver a range of labour market assistance programs that aim to improve people's readiness for the labour market and increase participation and productivity. Many of these programs address the individual circumstances that might make it harder for a person to find suitable work – including a disability, mental illness, language barriers or having been out of the paid workforce for a long period of time. These programs are integrated with income support (or welfare) payments, so that the ability of individuals to receive continued income support is often tied to them making genuine efforts to find paid work. In Australia, a national agency called Centrelink oversees individuals' access to income support and their interaction with labour market programs.

Employment services – matching people to jobs and giving them adequate training – are contracted through a network of government-funded employment services agencies. This $1.3 billion network, called the New Employment Services Model, provides funding for employment agencies to prepare unemployed people for work and place them into available jobs. Employment agencies are provided with higher payments for successfully helping the long-term unemployed find work.

A major long-term goal of labour market policies is to increase and sustain participation in the workforce. The Australian Treasury's *Intergenerational Report* predicts a long-term decline in workforce participation, driven by the ageing of the population. Maintaining high workforce participation, including keeping older people in the workforce, will be needed to generate tax revenue that can offset the growing costs of the ageing population. Measures taken to increase workforce participation include:

- During the COVID-19 pandemic in 2020 and 2021, the Government established a JobMaker Hiring Credit aimed to prevent a rise in long-term unemployment among younger people. JobMaker allowed businesses to claim $200 per week for new employees aged 16 to 29 and $100 per week for those aged 30 to 35.
- In 2023, the Albanese Government announced a major overhaul of Australia's immigration system. The reform plan creates a three-tier system: a lower-wage segment in specific sectors with labour shortages, such as aged care; a mid-level segment for jobs paid above a new temporary skilled migration threshold of $70,000; and a lighter-touch approach for highly paid, high-skilled migrants.
- Another feature of the reform plan is making it easier for temporary skilled migrants, who are typically younger workers, to become permanent residents. This helps to reduce the average age of the working population and increase participation rates over the longer term.
- Among its smaller-scale labour market policies, the Government funds job fairs and provides payments of up to $6,000 for workers moving to rural areas to work in agriculture (known as AgMove).

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- The 2023–24 Budget announced plans to increase paid parental leave from 18 to 20 weeks from 2023, rising to 26 weeks' leave by 2026. This aims to sustain higher levels of participation in the workforce, especially among women.
- Australian governments have substantially increased funding for childcare, both to expand eligibility for subsidised care and to address shortages of skilled workers in this sector. Increased availability of childcare makes it easier for parents to combine work and caring responsibilities for young children.
- Reforms to the interaction of the tax and welfare systems, to reduce high "effective marginal tax rates" (EMTRs). High EMTRs mean that for every extra dollar that welfare recipients earn, they have to pay tax as well as lose a portion of their welfare benefit, and this can undermine incentives to find paid work.

### reviewquestions

1. Discuss the impact of increasing the quality of education on the labour market.
2. Identify TWO labour market policies that aim to reduce unemployment.
3. Explain why increased workforce participation is a priority for labour market policy.

## 17.7 Evaluating labour market outcomes in Australia

Australia's labour market has a hybrid system of wage determination that emphasises market forces through enterprise bargaining, while retaining some non-market forces such as labour market institutions like the Fair Work Commission. In concluding this chapter we review some of the evidence about the performance of the system in recent years, noting that many factors other than labour market policies can shape outcomes in the labour market.

In overall terms, under enterprise bargaining Australia has sustained moderate wage increases, low inflation and relatively strong employment growth. The shift to a decentralised industrial relations system appears to have contributed to Australia's recent economic outcomes in several ways:

- **Wages growth and inflation**. A key macroeconomic goal for the wage determination system is to sustain a level of wage growth that strikes a balance between stable, low inflation outcomes and real income growth for wage earners. Wage outcomes during recent decades have been consistent with sustained low inflation, but have delivered low increases in real wages. The flexibility of the decentralised system has allowed larger wage rises in specific areas where strong wage pressures exist, without this spilling over to wage increases across the board. The low overall wage outcomes of the late 2010s even prompted the former Reserve Bank Governor, Philip Lowe, to advocate an increase in wage growth in order to increase spending and strengthen economic growth. However, concerns about inflation returned in 2022 following a sharp spike in inflation across the world. Policymakers wanted to prevent the inflation surge from increasing inflationary expectations and creating an inflationary wage spiral. As noted in figure 17.7, wages growth accelerated in 2022–23 but remained well below the rate of inflation.
- **Work practices and productivity**. The deregulation of the labour market since the 1990s has helped to bring about major changes in Australian work practices. Australia experienced its best sustained productivity growth performance on record during the 1990s, averaging 2.1 per cent per year as enterprise agreements

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eliminated old, outdated work practices. However, these were one-off gains from reforms, and productivity growth has averaged just 0.6 per cent since the 2010s, according to the ABS. Many other advanced economies have been experiencing low productivity, and economists have differing views about the role of skills, technology, research and development, and regulation in influencing productivity outcomes. To the extent that workplace arrangements can influence future productivity growth, in its recent 5-Year Productivity Inquiry, the Productivity Commission questioned the effectiveness of the enterprise bargaining system.The report cited evidence that bargaining objectives were mostly about wages growth and minimising the risk of industrial action, not driving productivity growth. It recommended that agreements ban the inclusion of clauses that limit productivity-enhancing changes to technology, and that the Better Off Overall Test should be made more flexible so that agreements could be made even if some workers were worse off, provided "the benefits to winners are larger than the losses to losers".

- **Unemployment**. Reforms to the wage determination system have provided Australian workplaces with greater flexibility to adjust to fluctuations in the business cycle. In overall terms, Australia has been successful in combining lower unemployment with rising wages and productivity since the 1990s. In mid-2023,

## THE MYSTERY OF AUSTRALIA'S WAGE GROWTH

One of the most surprising features of wage outcomes during the 2010s was that despite low unemployment levels and persistent skills shortages, wage growth remained weak throughout the decade. Figure 17.7 shows that throughout the 2010s, the Treasury forecast an upturn in wages growth in Australia, but it never materialised. The average national pay increase was just 2 per cent for the five years between 2015 and 2020, and annual real wage growth fell to just 0.5 per cent.

In 2022–23, nominal wages grew substantially for the first time since the global financial crisis, increasing 3.7 per cent in the year to March 2023. However, inflation outpaced income growth, rising to a 30-year high of 7.8 per cent over the same period. This means real wages fell 4.1 per cent. Economists debated whether wages growth should be kept below inflation, to prevent locking in a higher inflation rate, or whether they should keep pace with inflation, to preserve living standards for low- and middle-income earners.

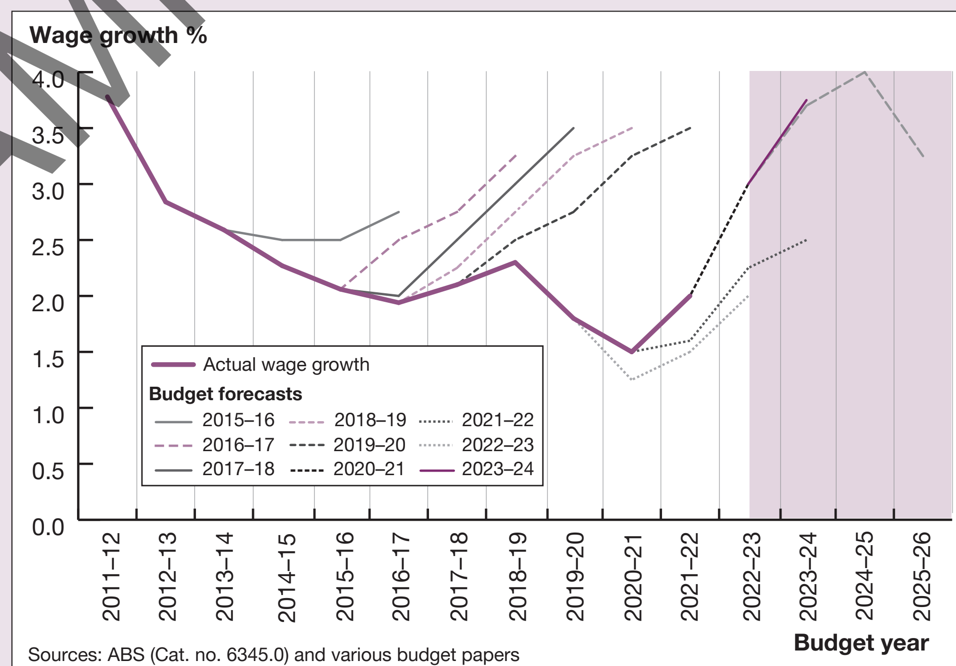


**Figure 17.7 –** Forecast and actual wages growth

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Australia's unemployment was 12th lowest among the OECD's 38 economies, despite the fact that Australia has the highest minimum wage levels in the OECD. The labour market's record of responding flexibly to changing circumstances was shown following COVID-19, with unemployment falling below 4 per cent for the first time since the 1970s.

- **Income inequality**. One of the negative effects of decentralised wage determination is a widening of the gap between higher- and lower-income earners. Workers with greater skills and who belong to stronger unions tend to receive larger wage increases under enterprise agreements, whereas those with lesser skills and in weaker bargaining positions do not. Although the past three decades of enterprise bargaining have resulted in a widening of income inequality, the safety net of awards and minimum wage increases has modestly increased real wages for the lowest-income earners. In the decade to 2020, while consumer prices rose 22 per cent, the national minimum wage rose 32 per cent – slightly faster than the increase in the overall wage price index of 29 per cent. On the other hand, employees at the top of the earning scale have enjoyed the fastest income growth – for example, in 2022–23 the average income growth of CEOs of large Australian companies was 15 per cent, more than four times that of the average worker.

For well over a century, Australians have been debating how the economy should set wages and conditions for workers. This is unsurprising given that labour is the largest cost item for most businesses (on average, labour is around 60 per cent of business costs). Policies that influence labour costs therefore have a major impact on individual businesses and the economy overall. At the heart of this debate are different views of the role of market forces and non-market forces in Australia's wage determination system. Historically, Australian governments have believed that because employers possess unequal bargaining power over individual employees, non-market institutions such as industrial tribunals are needed to ensure outcomes that are fair to employees. In fact, Australia was among the first nations in the world to recognise minimum entitlements for employees, such as the eight-hour day and the right to a minimum wage that was high enough to support a decent standard of living for a family. In its first term in office, the Albanese Government has given priority to reforms to the *Fair Work Act*, to strengthen both the role of the Fair Work Commission and the bargaining power of workers – reflecting the fact that long-running debate is ongoing.

The continued debate over workplace relations demonstrates that workplace issues remain as much a part of Australian economic policy debate now as they have been since Australia's Federation more than 120 years ago. The processes for determining wages, work conditions and work practices are among the most important aspects of economic policy because they have such wide impacts on the economy and on people's lives. For this reason, the debate over labour market policies and their impacts is likely to continue for many years to come.

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## reviewquestions

1. Explain the relationship between the industrial relations system and productivity outcomes.
2. Discuss the advantages and disadvantages of Australia's shift to a decentralised system of wage determination.
3. Analyse the impacts of industrial relations changes on employers and employees.

# chapter summary

1. While the Australian labour market has traditionally been governed by a combined system of federal and state laws, since 2009 Australia has had a unified national system for the private sector under the ***Fair Work Act***, which directly determines wage outcomes for around 7 in 10 Australian workers.

2. Australia's workplace relations system consists of three main streams – awards, collective agreements and individual contracts (common law contracts).

3. The **National Employment Standards** set out in law the minimum employment entitlements of all Australian employees. They include maximum weekly hours of work, annual leave, personal leave (including sick leave), parental leave, a right to request flexible working arrangements if caring for a child, a requirement of notice before termination and a right to redundancy pay.

4. **Modern awards** are a set of pay and conditions that are specific to an employee's work or industry sector, that provide a safety net of minimum wages and conditions. They include flexibility clauses so that employers and employees can vary the effect of an award.

5. **Enterprise bargaining** is a method of wage determination in which a workplace agreement is negotiated collectively between an employer and employees, often represented by unions.

6. **Common law contracts** are individual employment contracts that play a role outside of the formal industrial relations system. They apply automatically and to employees who have informal employment contracts that may provide above-award conditions.

7. In recent decades, Australia has shifted from a system in which industrial tribunals played the main role in **dispute resolution** to a system in which employers and employees are largely responsible for resolving their own disputes.

8. **Decentralisation** refers to a situation in which instead of decisions about wages being made by a government or a central industrial tribunal, they are made in individual workplaces such as through enterprise bargaining.

9. Decentralisation of wage determination can increase productivity and help prevent a flow-on of wage rises from one sector of the economy to another, but as a result can also contribute to greater inequality in the distribution of income.

10. **Labour market programs** are implemented to address unemployment that is related to supply-side factors such as frictional, structural and long-term unemployment. These programs attempt to reduce the non-accelerating inflation rate of unemployment by improving the skills, job-readiness and employment opportunities of people who are currently out of work.

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# chapter review

1. Outline the main features of Australia's national workplace relations framework.
2. Outline how the minimum entitlements of employees are determined.
3. Define *enterprise bargaining*. Explain the role of enterprise bargaining in Australia's labour market.
4. Explain the role of the workplace relations system in influencing the level of inflation in the economy.
5. Discuss how wage earners who do not have a workplace agreement can achieve wage rises.
6. Describe how disputes between employers and employees are resolved under Australia's workplace relations system.
7. Explain the difference between a centralised and decentralised system of wage determination.
8. Describe the relationship between wage outcomes and productivity.
9. Discuss the arguments for and against increasing the use of individual contracts within the labour market.
10. Analyse the effectiveness of labour market policies in achieving government economic objectives in recent years.

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# 18 Effectiveness and Limitations of Economic Policy

**18.1** An overview of the effectiveness of economic management
**18.2** Limitations of economic policy
**18.3** Evaluating the effectiveness of economic policies

This chapter concludes our study of the Australian economy with a discussion of the effectiveness and limitations of economic policies. This ties together some of the themes of topic 3 and topic 4, as well as reviewing some aspects of the global economy from the first half of the book that impact the effectiveness of economic policies.

As a starting point, we can evaluate the effectiveness of government policies against the six objectives that were discussed in chapter 13:

1. economic growth and wellbeing
2. full employment
3. low inflation
4. external balance
5. an equitable distribution of income and wealth
6. environmental sustainability.

It is also important to consider the limitations of economic policy, including time lags, political constraints and global influences. We conclude by outlining how to evaluate specific policies, with reference to their objectives, implementation, and outcomes, and provide a general overview of the effectiveness of macroeconomic and microeconomic policies in Australia in recent decades.

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## 18.1 An overview of the effectiveness of economic management

Assessing the effectiveness of economic policies involves evaluating their outcomes against the objectives that they were implemented to achieve. Policy objectives change over time, and governments have changed how they prioritise different objectives over recent decades. Policymakers often need to choose between conflicting objectives (as discussed in chapter 13). It is also important to consider the wider context for economic management to assess the effectiveness of policy in addressing specific economic issues.

**Macroeconomic policies** are policies that affect the economy as a whole with the aim of minimising fluctuations in the business cycle. Also referred to as demand management or counter-cyclical policies.

Since the early 1990s, the roles of different economic policies have been defined in fairly clear terms. Overall, **macroeconomic policy** has aimed to achieve the maximum sustainable rate of economic growth. Australia's long-term potential growth rate has in recent years been revised down to 2.5 per cent, according to Treasury calculations in 2023.

However, when there is spare capacity in the economy, the economy can sustain a higher growth rate in the short to medium term (especially during recovery from a recession, as was the case in 2021–22). Achieving this goal has required balancing the objectives of stronger growth and lower unemployment against the objectives of keeping inflation within the 2 to 3 per cent target range and maintaining external stability. The goal of **microeconomic policies** has been to improve productivity and competitiveness, with the outcome of achieving a higher level of economic growth over the longer term (that is, lifting the sustainable rate of economic growth).

Australia's most distinctive economic achievement in recent decades is that it sustained the longest unbroken run of economic growth on record anywhere in the world, between 1991 and 2019, and that it recovered quickly from the COVID-19 recession. Australia's economic growth rate averaged 2.9 per cent during the growth cycle from 1991 to 2019, significantly stronger than the average 2.1 per cent growth rate among OECD economies during the same period. However in the second half of the 2010s it fell to just 2 per cent, only fractionally above the OECD average, and Australia's slowest growth rate for 60 years on a per capita basis.

Australia ranks well on comparative measures for living conditions and economic development. For example, Australia ranks fifth in the world on the Human Development Index. Global investment bank Credit Suisse in its 2022 *Global Wealth Report* ranked Australians first in the world by median adult wealth, with US$273,900. On the other hand, while it is still among the top 20 countries, Australia's ranking on the global Prosperity Index fell in the decade to 2023 by three places to 15th. The Prosperity Index, which is published annually by the Legatum Institute, ranks countries on the basis of a range of statistical factors, including economic growth, education, health, governance, human rights and environmental standards.

Australia's economic outcomes indicate the improved effectiveness of economic policies since the 1990s. Governments have managed the conflicts between economic policies better, and have generally not been forced to sacrifice one macroeconomic objective for another. This has been helped by reduced volatility in the economy, and governments have been able to strike a balance between their goals for growth, inflation, unemployment and external balance. In contrast, economic management in the 1970s and 1980s had been characterised by constant tensions over whether priority should be given to maintaining low inflation or reducing the level of unemployment, both of which remained high during those two decades.

In part, Australia's economic performance reflects more favourable external conditions than those of most other economies. Australia has benefited from its rich endowment of natural resources, which allowed it to take advantage of a historic rise in global commodity prices and the rapid industrialisation of China. Australia's terms of trade rose in the 2000s to almost double their average during the last quarter of the century, and again surged as the global economy emerged from the COVID-19 pandemic and as energy prices soared after Russia's invasion of Ukraine. Australia also benefits from strong population growth (one of the highest rates in the OECD) with a migration program that focuses on skilled migrants who increase the economy's productive capacity.

## Outcomes for growth, inflation, unemployment and external balance

One way to assess the effectiveness of economic policies is to examine specific economic outcomes. The sustained **economic growth** in the period from 1991 to 2019 was achieved because the economy avoided major fluctuations in the business cycle, such as where a boom in growth triggers a surge in inflation, which then needs to be curbed by contractionary policies such as high interest rates that might trigger recession. Stable economic growth was underpinned by relatively high population growth, resilient terms

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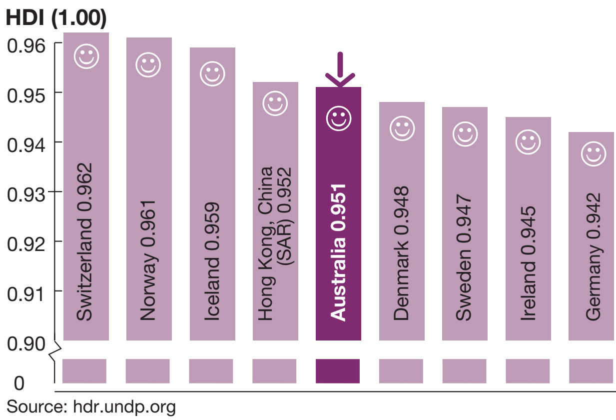
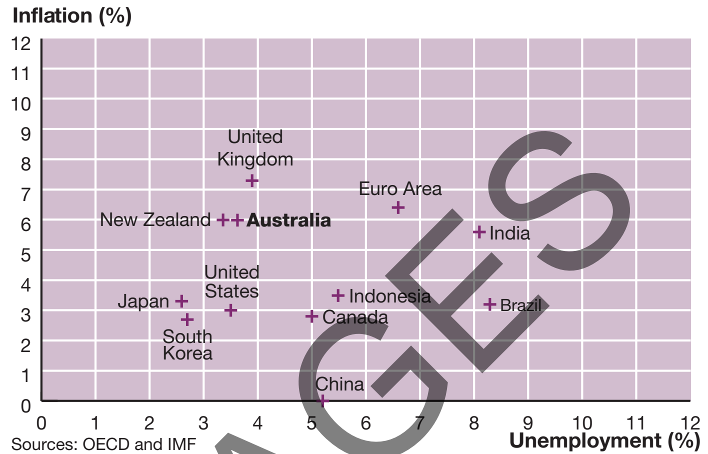
# HOW AUSTRALIA STACKS UP

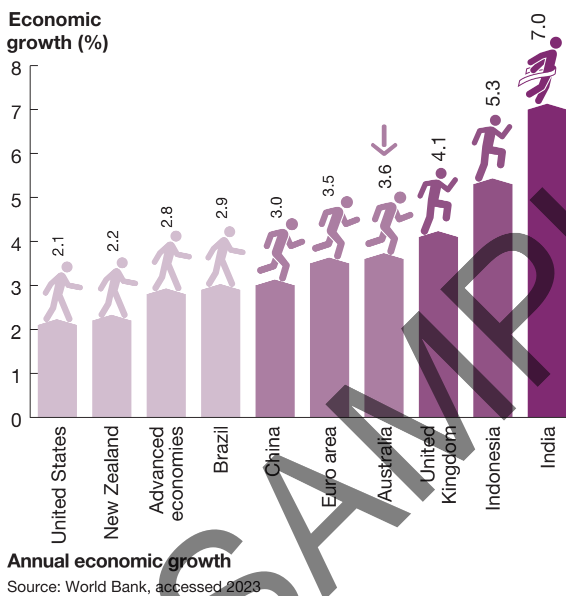
## OVERALL, AUSTRALIA IS AMONG THE BEST PLACES TO LIVE IN THE WORLD – WITH A VERY HIGH HUMAN DEVELOPMENT INDEX.



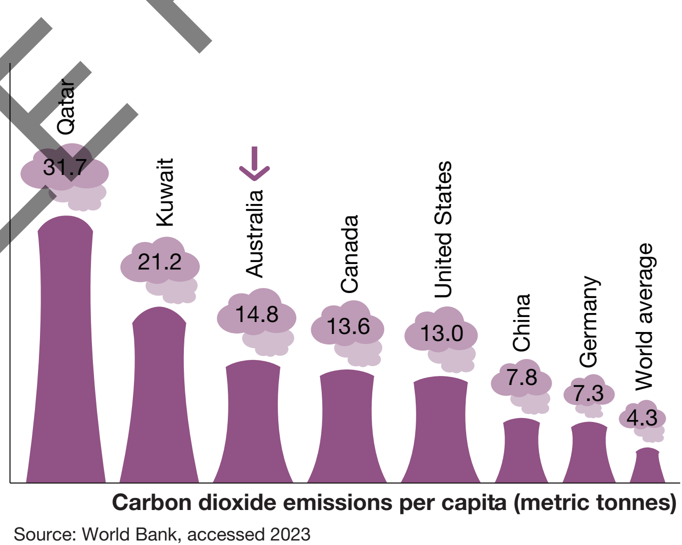

## LOW UNEMPLOYMENT AND AFFECTED BY SURGING INFLATION, LIKE OTHER COUNTRIES




## AUSTRALIA'S GROWTH IS ABOVE OTHER ADVANCED ECONOMIES.




## AS OTHERS REDUCE THEIR EMISSIONS, AUSTRALIA FACES BIG ADJUSTMENTS AS ONE OF THE LARGEST PER CAPITA EMITTERS OF GREENHOUSE GASES.

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of trade that underpinned export revenue, and high levels of workforce participation. On the other hand, Australia's growth rate has slowed in recent years (notwithstanding the volatility caused by the COVID-19 pandemic). Governments aimed for a sustainable growth rate of 3 to 4 per cent through the 1990s and into the 2000s, and more recently have aimed for growth above 3 per cent. Australia's slower growth (of 2.4 per cent) in the 2010s was below its long-term potential. After COVID-19, the long-term sustainable growth rate had fallen to 2.5 per cent, reflecting Australia's long-term trend of weak productivity growth, and the absence of major new sources of growth or investment.

Australia's **inflation** record since the early 1990s has been outstanding, notwithstanding the global surge in inflation in 2022. After averaging 10 per cent during the 1970s and 8 per cent during the 1980s, inflation has averaged around 2.5 per cent since the introduction of inflation targeting in the early 1990s. This was a result of several factors, including a clear and transparent framework for monetary policy, lower tariff

barriers, increased competition across many industry sectors, price reductions resulting from new technologies and cheaper imports, moderate wage outcomes and a period of strong productivity growth in the 1990s. Even during the mining boom, which brought about cost pressures and capacity constraints, Australia was successful in controlling inflationary pressures, and inflation has fallen more quickly than in other countries after its post-COVID-19 surge. Figure 18.1 shows Australia's economic performance since 1990.

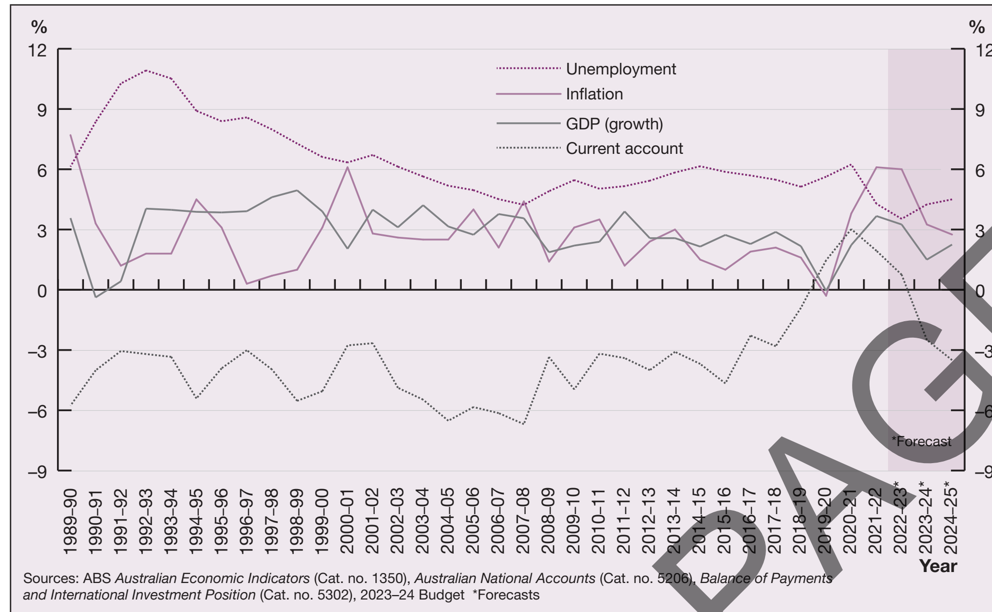


**Figure 18.1 –** Australia's economic performance since 1990

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Australia's labour market is generally regarded as having attained full employment during recent years. The unemployment rate was around 3.5 per cent in 2023, its lowest level in 50 years. While Treasury forecasts pointed to unemployment rising to 4.5 per cent, this was still lower than pre-pandemic levels of above 5 per cent. The strength of the labour market is also reflected in lower levels of underemployment. After growing to above 9 per cent in the 2010s, in 2023 it had fallen to just above 6 per cent.

Favourable external conditions have helped Australia to reduce its large **external imbalances**. The structural improvement in the current account and net foreign liabilities came about as a result of three major developments: China's emergence as Australia's largest export market, a remarkable turnaround in Australia's terms of trade and a long period of record-low global interest rates. In the decade to 2020, the current account deficit averaged around 2.3 per cent of GDP, compared with an average of 4 per cent in the previous three decades. The 2023–24 Budget forecast Australia would return to a current account, after four years of being in surplus. These surpluses reflected a combination of strong export prices, a fall in overseas travel during COVID-19, lower global interest rates during COVID-19 and a surge in energy prices following Russia's invasion of Ukraine. Despite an improvement in its external stability, Australia still has a high level of foreign liabilities and remains vulnerable to adverse external shocks, especially given its reliance on commodity exports and on China as its dominant export market. Australia's external imbalances nevertheless cause less concern now than in previous decades, and the fact that most external debt is denominated in Australian dollars reduces the economy's risk exposure.

While Australia has managed shorter and medium-term risks, its greatest long-term vulnerability may come from the impacts of climate change. Australia's ecological vulnerability has been demonstrated by natural disasters in recent years, including the 2022 floods in Queensland and northern NSW and the "Black Summer" bushfires that burned 186,000 km$^2$ of bushland across Australia in 2019–20. Agriculture, tourism and

## TIME FOR A PARADIGM SHIFT IN ECONOMICS?

For many decades, the economic reform debate in advanced economies has been dominated by the "Washington consensus" policies: reduced government intervention in markets, deregulation, trade liberalisation and privatisation of public assets. Those policies have been advocated by think tanks, business lobby groups and international bodies such as the IMF and World Bank. No other organisation has championed those policies more than the Organisation for Economic Cooperation and Development (OECD) – an organisation that brings together many of the world's leading economists to advise on economic policy for advanced economies, and which has been a major influence on Australian economic policy. Although the OECD never advocated a complete "laissez-faire" approach of governments not intervening in free markets, it paid limited attention to questions of inequality and focused strongly on increasing economic growth.

In the past decade, this has changed dramatically. The OECD now argues that its past approach failed. The world has seen weak growth and increasing inequality in the decade since the global financial crisis. In addition, there is a widespread backlash against globalisation and growing resistance to open trade in many countries.

In recent years, the OECD has called for a major paradigm shift in economic policy around the world. It is urging member countries such as Australia to focus on an agenda of inclusive growth. This approach emphasises issues of income and wealth distribution and economic opportunity, alongside growth. The inclusive growth agenda does not abandon the OECD's historic commitment to market-based mechanisms. But it requires a more active long-term role for government in addressing the inequalities that now pose a growing threat to the stability and social cohesion of many countries. Among other policies, the OECD's Inclusive Growth Initiative urges governments to:

- remove distortions in tax systems that are contributing to inequality (such as capital gains tax concessions, loopholes exploited by multinational companies and the exclusion of housing and inherited wealth from tax systems)
- invest in early childhood development programs (currently, a child born to parents who did not complete high school has a 15 per cent chance of going to university, while there is a 60 per cent chance for a child born with at least one parent who has a university degree)
- support young firms and small and medium-sized enterprises by reducing the barriers to entry to markets, encouraging research and development, and making it easier to obtain finance.

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regional economies are especially vulnerable to these impacts. Australia has a poor record in preserving its biodiversity, protecting natural environments, managing scarce water resources and overusing agricultural land. Australia has also made slower progress than other economies in reducing its carbon emissions as one of the world's highest emitters of greenhouse gases per capita, with a heavy reliance on carbon-intensive fossil fuels for both energy generation and export income. Political disagreements over the economic policy response to climate change and frequent policy changes have also resulted in policy uncertainty for the past 15 years, further complicating Australia's pathway to reducing emissions. Despite commitments to achieving net zero emissions by 2050, Australia will face ongoing challenges in the decarbonisation process, such as shifting Australia's coal-dominated electricity market to renewable energy sources.

Another longer-term concern is that despite an unprecedented period of sustained economic growth and falling unemployment, Australia has experienced an increase in inequality in its **distribution of income and wealth**. Like other advanced economies, Australia has experienced a shrinkage of middle-level jobs alongside growth in earnings at the top end and an expansion of lower-paid service industry jobs. Rising property prices have contributed to a widening gap in wealth inequality. A Productivity Commission report in 2018 found that, while the evidence is mixed, in overall terms inequality has

increased in the past three decades, with the fastest growth in income and wealth occurring among the highest earners. A 2021 Productivity Commission report also highlighted disparities between young and older people, which are exacerbated by the high cost of housing in Australia.

The impact of rising inequality has been intensified by a decline in wage growth during recent years. Since 2015, wage growth in Australia has been below the average for OECD economies, following a long period in which Australians became accustomed to some of the highest levels of real wage growth in the world. Together, slow wage growth and rising inequality are contributing to some Australians feeling left behind by globalisation and technological change. In addition, specific groups of Australians are disproportionately affected by entrenched social disadvantage, including Indigenous Australians and people who are excluded from the labour market.

## reviewquestions

1. Discuss the extent to which the goals of economic management have been achieved in Australia in recent years.
2. Assess the role of macroeconomic policies, microeconomic policies and international factors in influencing Australia's economic performance in recent years.

# 18.2 Limitations of economic policy

Several factors can constrain the effectiveness of economic policies and affect whether or not the policies achieve their goals. Below we note three key factors that can influence the effectiveness of policies: time lags, political constraints and global influences.

## Time lags

There are two types of time lags that can limit the effectiveness of economic policies. **Implementation time lags** exist when it takes time for the government to make changes to or introduce new economic policies. **Impact time lags** exist when it takes time for a new policy or a policy change to have an impact on the economy. Both of these time lags are summarised for different policies in figure 18.2. A change in **monetary policy** can be implemented very quickly. Under changes effective from 2024, the Reserve Bank holds eight scheduled meetings per year, usually towards the start of the month. The outcome of the meeting is announced to financial markets at 2.30pm on the second day of the meeting. In some extreme situations, however, the RBA Governor may be given the discretion to change interest rates if conditions change during the period of time between RBA meetings. Once the decision is announced, it has an immediate effect on the cash rate.

| Policy | Implementation time lag | Impact time lag |
|---|---|---|
| **Fiscal** | Medium term (annual Budget) | Short term (a few months) |
| **Monetary** | Short term<br>(monthly RBA meeting) | Medium term (6–18 months) |
| **Microeconomic reform** | Long term (a few years) | Long term (up to 20 years) |

**Figure 18.2 –** Policy time lags

On the other hand, the implementation of **fiscal policy** can take a substantial amount of time. Major changes to fiscal policy usually occur annually with the Budget. Substantial changes to spending or revenue collection are mostly made at the time of the Budget, although a government can also announce fiscal policy changes between budgets (in fact,

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the largest fiscal policy changes ever made, in response to the COVID-19 pandemic, were announced outside of the normal budget cycle as emergency measures). Most spending and revenue changes need to go through a complex process of budget committee meetings and will be scrutinised by several government departments before being approved. The process of developing each year's Budget starts early in the year and runs for several months until the Budget is finalised in May. It can then take several months for budget legislation to pass through Parliament, and as discussed in more detail below, political constraints can sometimes stop governments from implementing their budget proposals.

Similarly, changes to **microeconomic policies** can take a long period of time. This is because of the planning and complex policymaking involved in microeconomic policies. Microeconomic policy can also take a lot of time to implement if it is necessary to secure the support of state governments as well as the Commonwealth. For example, introducing a national energy policy, reforming Australia's system for schools funding, implementing uniform consumer protection laws and introducing a national disability insurance scheme all required the support of the six states and two territory governments. The process of negotiating these changes often takes a considerable time because of the different interests of each state.

Policies can also take time to achieve their aims due to the differing time lags in their **impacts**. Some policies will take effect in a relatively short time period – for example, while it takes a long time to implement changes in fiscal policy, these changes can have a quick effect on economic activity. A tax reduction can immediately affect income levels or prices, and an increase in government spending can quickly affect economic conditions. The impacts of shorter-term changes in the stance of fiscal policy can generally be seen within a year. Fiscal policy therefore becomes more important during a downturn, as fiscal policy's shorter time lag in impacting the economy makes it the most effective policy to achieve an immediate boost in aggregate demand. This was evident in the Government's rapid expansionary fiscal policy response to shocks such as the global pandemic in 2020 and the global financial crisis in 2008–09.

On the other hand, there is a time lag of up to 24 months for monetary policy changes to have an impact on the economy. This is because it takes some time for changes in the level of interest rates to feed through to changes in the borrowing and savings behaviour of consumers and businesses. Part of the challenge for the Reserve Bank is to adjust monetary policy pre-emptively, based on the future level of inflation and other economic conditions that it expects in a year to 18 months' time, to address this impact lag. The monetary policy time lag has more recently lengthened from 18 months to as long as 24 months because of the higher share of households on fixed-interest rate mortgages (which shot up from around 20 per cent to around 40 per cent during the COVID-19 pandemic). This means that for some households, interest rate increases in 2023 may not be felt until 2025.

The impacts of microeconomic policies can probably only be assessed after a period of several years, and perhaps decades, if we are to get a fuller picture of the effectiveness of these policies. The benefits of structural change can take several years to become apparent as resources are reallocated from one sector to another, and the full effects of those changes flow through to costs, business profits, export growth and productivity. In addition, it can be difficult to accurately measure the impact of microeconomic policies since several microeconomic policies might be implemented at the same time and it may be hard to distinguish the impacts of one reform from another.

## Political constraints

Economic policy decisions are made in a democratic context. Governments in Australia are elected to represent the public, and often have specific election commitments that they are responsible to deliver. Once elected, governments can face difficult trade-offs in making decisions that are consistent with their commitments and compatible with

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economic conditions, and that will be passed through the Parliament. For example, the Morrison Government was elected in 2019 with a commitment to sustain budget surpluses but instead, due to the COVID-19 pandemic, delivered the largest budget deficits in Australian history.

Governments must be sensitive to public opinion in developing and implementing economic policies. Governments also consider whether a policy will be supported by members of their own political party, and by other stakeholders, and whether that policy might also be opposed by specific groups. Typically, governments implement longer-term (and less popular) policies in the first year of the three-year term. In the year before an election, governments can be reluctant to make unpopular decisions and are often under pressure to implement policies that are popular with the electorate but may not have long-term economic benefits.

The constraints on implementing **unpopular policies** are a major consideration for economic management. Unpopularity has become the largest barrier to economic reform in Australia in the past decade, according to a report in 2021 from the Grattan Institute at Melbourne University. It has become less common for governments to implement unpopular reforms to achieve long-term economic goals, as happened in 2012 with the Gillard Government's introduction of a carbon tax and in 2000 with the Howard Government's introduction of the Goods and Services Tax.

Governments can delegate authority for some decisions to independent government agencies to minimise these political constraints. For example, the Reserve Bank makes interest rate decisions and the Fair Work Commission decides on increases to the national minimum wage and award wages. In addition, independent authorities approve pricing decisions in regulated sectors like postal services and electricity prices. A government responsible for making these decisions would be under political pressure to make short-term, popular decisions, which might not be consistent with long-term economic objectives.

Another aspect of the political constraints on government is the role of the Australian Parliament, and especially the **Senate**. Many economic policies can only be implemented through legislation, including budget measures, changes to the industrial relations system, and changes to business laws. Under the Australian parliamentary system, legislation must receive a majority of votes in both the House of Representatives (the Lower House) and the Senate (the Upper House). Historically, it has been uncommon for a government to have a majority in the Senate, and as a consequence governments have to make compromises to win the support of other senators, from either the Opposition or minor parties, to pass the proposed legislation. Elections in recent years have mostly led to very small majorities in the House of Representatives, and neither party winning a majority in the Senate, which has made it harder to implement changes.

In the May 2022 election, the Albanese Labor Government was elected with 77 out of 151 seats in the House of Representatives (a majority of just one), and only 26 of the 76 seats in the Senate. This means that to pass legislation, the Government has two options: either secure support from the Opposition (the Liberal/National Coalition), which holds 32 seats, or from the Greens (who hold 12 votes) plus one of the six other Senators (2 Lambie Network, 2 One Nation, 1 United Australia Party and 1 Independent). While the Government was successful in having most of its election commitments approved in the Senate, it was unable to secure a majority of votes for its plan to increase social housing, involving the creation of the Housing Australia Future Fund. Some senators opposed it for going too far, and another group of senators opposed it for not going far enough. Combined, the two groups of senators were able to block the legislation.

Australia's system of federalism can act as another political constraint on the Commonwealth Government. The Commonwealth and state governments share responsibility for major parts of the economy, including energy policy, the education system, health care, aged

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care, business regulation, and infrastructure such as roads. This means that to implement major changes, the Commonwealth often must win the cooperation and agreement of some or all of the states. The Commonwealth's greater capacity to raise revenue means it can offer financial incentives to achieve reform progress. For example, in August 2023, the Albanese Government provided $3 billion to states and territories and $500 million to local governments in return for planning reforms that would help achieve an increased target of 1.2 million new homes built over the following five years.

When the Commonwealth and the states are unable to agree on a policy compromise, the Commonwealth might try to impose changes on the states, a step that can lead to lengthy constitutional challenges in the High Court. In 2006, for example, the Commonwealth won a major constitutional case in which the states challenged its takeover of their industrial relations powers. The High Court has generally favoured an expansive interpretation of the power of the Commonwealth over the states in recent decades, but the states still retain significant powers under the Australian Constitution.

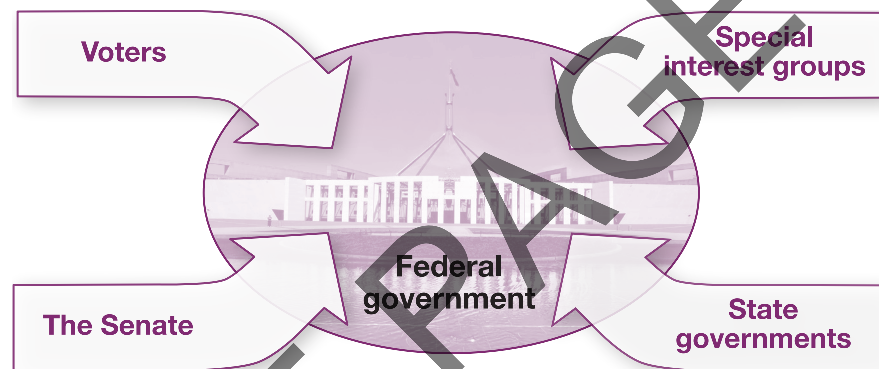


**Figure 18.3 –** Political constraints on economic policy

**Special interest groups** can also play an important role in government policymaking. Often, political parties have strong relationships with supporters – business groups tend to have significant influence on the policies of both major political parties, especially the Coalition parties, while unions have a close relationship with the Labor Party. Large businesses often employ lobbyists to influence government policies because of the potential financial impacts of policy decisions on their activities. Interest groups are especially active on the numerous policy debates relating to climate and energy policies, where coal, gas and other fossil fuel interests are frequently in dispute with environmental and climate organisations. Examples of recent policy debates include proposals to introduce a windfall profits tax on the oil and gas industry, increase the royalties tax on Queensland's resources sector, lift Australia's carbon emissions reduction targets, and allow for the building of new coal mines.

## Global influences

As the Australian economy has become more integrated with the global economy, global factors have become a greater constraint on economic policy. The constraints imposed by globalisation work at many levels. Conditions in the global economy have a more immediate impact on Australia. Economies often face immediate consequences for economic mismanagement, mainly through the reaction of financial markets. Governments also voluntarily accept constraints on their own economic policy in order to win concessions from other nations, such as through trade agreements.

In a global environment in which exchange rates and economies are vulnerable to sudden shifts in financial flows, governments place a high priority on maintaining the confidence of international investors and **global financial markets**. This has become particularly important in recent years with global financial markets experiencing enormous volatility following the global financial crisis and the pandemic. As we saw in chapter 5, foreign

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exchange markets tend to support policies that promote stronger trade and financial linkages to the global economy, and support economic and financial stability. These policies include:

- reduced government spending and reduced budget deficits
- low rates of corporate and capital gains taxes
- reduced trade barriers and openness to foreign investment
- deregulation of the financial sector, including the removal of restrictions on international financial flows
- deregulation across most areas of the economy, with the aim of increasing competition
- privatisation of government-owned businesses
- deregulation of labour markets and better targeting of social welfare
- trade agreements that give overseas businesses the power to take legal action against national governments if policy changes undermine the profitability of their investments.

**Appendix B:** Advanced Economic Analysis at the back of this textbook looks at "crowding out", the twin deficits hypothesis and the quantity theory of money – theories that explain the limitations of macroeconomic policies.

Governments face constraints if they wish to adopt policies that differ from the generally accepted formula for good economic management. Most advanced economies have adopted a similar policy mix in recent years. Critics argue that global financial markets effectively restrict the policy options available to governments, while others argue that financial markets are effective in disciplining governments that might otherwise make bad policy decisions. A government that adopts alternative policies may face a loss of foreign investor confidence and a fall in their currency. For example, ratings agency Fitch took away the US Government's triple A credit rating in 2023, citing its political instability and the way that political disputes in Congress had almost led to a default on the US Government's debt.

Global financial flows and overseas interest rates can also directly influence the conduct of monetary policy. If interest rates are rising in other countries, a country's rate of return will be relatively less attractive for overseas investors. This might result in an outflow of funds and a depreciation in the currency, which in turn may add to inflation and undermine confidence. In order to prevent this, governments will often adjust interest rates in response to changes in other economies. For example in 2022, increases in Australian interest rates mirrored rising global interest rates, as inflationary pressures rose across the world. Market interest rates in Australia can also be directly affected by changes in overseas interest rates, because Australian banks rely on borrowing from overseas to fund their loan portfolios.

The **international business cycle** can also restrict the scope of policymaking within individual countries. It is difficult for a country to significantly increase its level of economic growth if the global economy is in an economic downturn. Faster domestic growth will cause an increase in imports while export growth weakens, resulting in a substantial increase in the current account deficit. This can force the government to slow down the economy through tighter fiscal and monetary policy, risking a more severe recession. This is one reason why industrialised countries generally keep their economic growth in step with both the international and regional business cycle.

Finally, **international organisations** can have a direct influence on domestic macroeconomic and microeconomic policies. The **World Trade Organization** (WTO) can influence individual trade policies because of its enforcement powers. On occasion, the WTO has forced the Australian Government to change export assistance policies or Australia's strict quarantine regulations – such as when Australia was forced to abandon its ban on fresh salmon imports from Canada. Other international forums can also influence economic policymaking, such as the international pressure placed on Australia to step up its climate change commitments ahead of the UN Climate Change Conference in Glasgow in 2021.

Decisions of the **Group of Seven** (G7) nations and the **G20 group** (see chapter 2) can have a significant influence over the global economy and the domestic macroeconomic policies of small countries such as Australia. The growing integration of economies through

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globalisation leaves limited scope for small countries to adopt a different macroeconomic policy stance to that adopted by the major industrialised economies.

## reviewquestions

1 Explain how time lags limit the effectiveness of economic policies.

2 Outline two major economic policy initiatives undertaken by the Government during the past year, and for each:
   - Summarise arguments for and against the initiative as raised by any special interest group or the media.
   - Discuss how the initiative may have been influenced by political factors.

3 Discuss how the separation of monetary policy decisions from the control of the Commonwealth Government to the Reserve Bank might influence the effectiveness of the policy mix in Australia.

4 Briefly discuss how global economic conditions have constrained or assisted Australia's economic performance in the past year.

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## 18.3 Evaluating the effectiveness of specific policies

To examine the effectiveness of economic policies we must look at individual policies and determine whether or not they have been effective in achieving their goals in comparison with other policies. This can be a challenge because it is often difficult to isolate the specific effects of one policy compared with another. However, we can assess the effectiveness of policies by analysing:

- the specific objectives of a policy
- whether the policy was implemented effectively
- the relevant economic outcomes, and how they compare with the objectives
- time lags
- other factors that may have affected outcomes during that period, including external factors
- whether there were any side effects associated with policy implementation.

In evaluating whether a policy has been effective, we need to identify the policy's original objective. For example, in evaluating the effectiveness of monetary policy we first identify that the Reserve Bank's goal is to keep inflation within a target range of 2 to 3 per cent over the medium term. With this objective, monetary policy over the past two decades at the very least would appear to have been successful. If its target was to achieve zero inflation, then we would conclude that it has failed to achieve its objective.

The next question to ask is whether the government **actually implemented** the policy that it had originally set out to implement. Policies might be changed before they are fully implemented, for example, if a government is voted out of office or has changed its priorities. In addition, sometimes governments have economic policies that they are not able to implement because of political constraints.

For further information on Australia's economic performance and policies, visit the OECD website, and the Treasury website.

The next step in evaluating policies is to review the **economic outcomes**, and how closely they relate to the policy objectives. Sometimes it is difficult to determine whether a policy has been successful, because governments do not always set themselves specific targets or objectives when they implement a policy. For example, governments have set targets for economic growth and inflation during recent years, but not for unemployment, other than a general aim of reducing the rate. Without specific goals, it is more difficult to measure the effectiveness of policies.

The next step to is ask **whether other factors significantly affected the economic outcome**. Government economic policy is always at the mercy of other developments, and economic policy is often just one of many factors that determines economic outcomes. Economists often speak of policies being effective in terms of the Latin phrase "ceteris paribus" – meaning "with everything else being the same" or effectively, "if nothing else changes". The problem in measuring the effectiveness of policies is that other things do change. For example, per capita growth in greenhouse gas emissions fell in the years after Australia abandoned the carbon tax in 2014. However, this was not because of the policy change. Other factors had a larger effect, including reduced fossil fuel emissions given the closure of large-scale manufacturing, oil refineries and aluminium smelters, reduced household demand due to higher energy prices, and the rapid take-up of residential solar power.

Some of the factors that might affect economic outcomes include:

- changes in global economic conditions or the economy of a major trading partner
- overseas interest rate movements
- a sharp movement in the value of the currency
- developments that might affect future expectations, such as a crisis in a particular industry or region of the world
- changes in commodity prices and Australia's terms of trade, such as a fall in oil prices or a rise in iron ore prices
- developments in our natural environment, including droughts, floods, natural disasters and pandemics
- industrial unrest, such as a dispute between a union and a major company
- new technologies or shifts in consumer preferences
- a shift in investor and consumer confidence relating to the economy, for example, as a result of a downward adjustment in credit ratings.

The final question to be considered is whether a policy had any **other consequences** or side effects. This is especially important to ask if there are signs that the policy was reasonably effective in achieving its main aim. At this point, we might ask: at what price was this achieved? Was another part of the economy badly affected by this policy? This highlights the trade-off between policy objectives because of the **conflicting objectives** of economic management. For example:

- There is a short-term trade-off between reducing inflation and reducing unemployment. When inflation exceeds the Reserve Bank's two to three per cent target band, it may be necessary to raise interest rates to reduce inflation, typically resulting in a short-term contraction in economic activity and increased cyclical unemployment. It could be tempting for the Government to avoid taking action against inflation using contractionary macroeconomic policy, particularly during an election year. This is why the Reserve Bank operates independently from the Government, to prevent political considerations from constraining the conduct of monetary policy in achieving price stability. This trade-off came into focus in 2023, with the new RBA Governor Michele Bullock saying unemployment has to rise to return inflation back to target.

> "The unemployment rate is expected to rise to 4.5 per cent by late 2024. While 4.5 per cent is higher than the current rate, this outcome would still leave us below where it was pre-pandemic and not far off some estimates of where the NAIRU might currently be …
>
> Our goal is to return the labour market (and the market for goods and services) back to a level more consistent with full employment – something like the endpoint in our forecasts. We think this can be achieved if employment and the economy more generally grow at a below-trend pace for a while. This would help to bring demand and supply into better balance and give us the greatest chance of securing sustainable full employment into the future."
>
> *– Michele Bullock, (then) Deputy RBA Governor, Speech to Ai Group, 20 June 2023*

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- The COVID-19 pandemic forced governments at a state and federal level in Australia to make difficult trade-offs between maintaining economic activity and the public health risks associated with travel and interaction. Lockdowns and closures of Australia's international and state borders cost the economy tens of billions of dollars, but governments assessed that the consequences of not taking those measures would have been even worse.
- In recent years economists have raised concerns about excessive growth in housing prices in Sydney and other cities, and whether Australia's household debt levels are sustainable. Some economists have argued that greater controls should be imposed on lending for housing. However, such measures would also result in lower levels of economic activity and household incomes.
- When economies have high public debt levels, governments must make difficult trade-offs between reducing their budget deficit (to address financial market concerns about public debt levels) and the risk that contractionary fiscal policy could put their economy back in recession. Australia has not faced this difficult trade-off in recent years, because it has had much lower deficits and debt levels than other advanced economies, but several Europeans economies face this constraint.
- Economists have historically accepted that there is a trade-off between achieving higher levels of economic growth and increased inequality in the distribution of income and wealth. In particular, "boom" periods (such as the resources boom in Australia, or the rapid growth in the Chinese economy in the past three decades) often generate income and wealth that is distributed very unevenly. Traditionally, it was thought that countries must accept higher levels of inequality if they wish to achieve faster growth. However, organisations such as the OECD and IMF now emphasise the need for a more inclusive approach to economic growth, because of the negative economic and social effects of increasing inequality. Advocates of inclusive growth argue that policies to promote greater income equality will boost economic growth (because measures to increase the incomes of lower-income earners will boost consumption, and therefore growth). This suggests that there is no longer a clear trade-off between increased equality and increased growth.
- In 2022, Australia legislated its commitment to reduce its carbon emissions to "net zero" by 2050. However delivering on this commitment will require structural changes to the Australian economy over the next quarter century, which in turn will require greater certainty and stability in policy settings. For the past two decades Australian governments have regularly changed their climate and energy policies or have had their proposals rejected in Parliament. There has been extensive debate about how policies that put a price on carbon emissions might affect different parts of the economy, especially carbon-intensive industries in regions like Wollongong, Newcastle and the Hunter Valley. Governments have been forced to make trade-offs between the long-term goal of reducing greenhouse gas emissions and the short-term impact of a carbon price, including higher energy prices, slower economic growth and potential job losses.

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Examining the side effects of economic policies, such as those discussed above, can help us to reach a more balanced assessment of the effectiveness of the policy mix.

## Economic management in Australia: Past, present and future

### Macroeconomic management

**Macroeconomic management** has mostly proved effective in achieving its **short- to medium-term goals** since the early 1990s. Economic growth has been sustained alongside low inflation and relatively low rates of unemployment. When the global COVID-19 pandemic forced the economy into recession in 2020, Australia was in its 29th consecutive year of economic growth: a world record. Australia recovered quickly from the COVID-19 recession, with unemployment falling to its lowest level in almost half a century.

**Monetary policy** has worked well since the early 1990s in managing the growth cycle and achieving price stability. The inflation target has largely been achieved (notwithstanding occasional periods of inflation outside the target, as has recently occurred) and Australia has maintained stable economic growth.

| | |
|---|---|
| **Early 1990s: Expansionary** | Expansionary fiscal and monetary policies were needed to bring about a gradual economic recovery. |
| **Mid-1990s: Contractionary** | Monetary and fiscal policy were both successfully tightened, addressing growing pressures on inflation and the current account by 1996. |
| **Late-1990s: Expansionary then contractionary** | The macroeconomic policy mix changed as tighter fiscal policy was offset by looser monetary policy between 1996 and 1998, and interest rates began increasing to head off rising inflation rates with the introduction of GST in 2000. |
| **Early 2000s: Expansionary** | As the global economy dipped into recession in 2001, Australia shifted to expansionary fiscal and monetary policies – with interest rates falling to their lowest levels in 30 years – and avoided recession. |
| **Mid-2000s: Contractionary** | As the Australian economy returned to normal growth rates, both fiscal and monetary policy became less expansionary to avoid excessive growth and increasing inflationary pressures from the boom in commodity prices. By 2007, monetary policy was contractionary. |
| **2008–2009: Strongly expansionary** | With the onset of the global financial crisis in late 2008, policy settings were reversed to provide a large expansionary stimulus for a weakening economy. Interest rates were reduced to their lowest level in 50 years, and the Government embarked on a massive fiscal stimulus to cushion Australia from the full force of the recession. |
| **2010–2019: Neutral stance** | As growth recovered, interest rates were returned to more neutral levels, while fiscal policy became mildly contractionary. From 2012, mildly contractionary fiscal policy was offset with expansionary monetary policy where interest rates were reduced to record lows. |
| **2020–2021: Strongly expansionary** | The COVID-19 recession prompted the most aggressively expansionary macroeconomic policy settings in Australian history, with a record-level deficit in 2020–21 and interest rates falling to their lowest on record. |
| **2022–2023: Mildly contractionary** | With the economy in recovery, the task of fiscal consolidation and stabilising debt re-emerged as a priority. Interest rates rose sharply as inflation surged in Australia and globally. |

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The effectiveness of monetary policy relies on the overall **policy mix.** The main limitation of monetary policy is that it is rarely effective when it is used on its own – it needs to be supported by similar fiscal policy settings. It is not effective when it is working in the opposite direction to fiscal policy, such as in 2008 when inflation had risen to 5 per cent, and interest rates had to be increased further to counter the inflationary effect of income tax cuts.

The past three decades have also shown that monetary policy is more effective in implementing contractionary macroeconomic policy than expansionary policy. During periods of major economic downturn or an extended period of sub-par growth, low interest rates are generally not enough to stimulate economic activity and lower unemployment. In an effort to support economic growth after they had already reduced interest rates to just above zero in response to the COVID-19 recession in 2020, central banks engaged in more unconventional monetary policy measures such as purchasing government debt ("asset purchase programs") from the private sector, providing low-cost credit to the banking sector and introducing a yield target for government bonds. The use of these approaches demonstrates that conventional monetary policy **can be ineffective** in an already low interest rate and inflation environment. Nevertheless, low interest rates can play a supporting role to expansionary fiscal policy in boosting economic growth. This

is because fiscal policy has a direct impact on aggregate demand, while monetary policy relies on households and businesses responding to interest rate incentives.

> "Flexible inflation targeting, and the RBA's actions within this framework, have been successful overall. The RBA has played a particularly critical role during crises, where it has acted decisively and effectively to support the economy and protect against severe outcomes … Flexible inflation targeting remains the best operational framework for monetary policy to pursue the dual mandate of price stability and full employment."
>
> – *Commonwealth of Australia (2023) An RBA Fit for the Future: Review of the Reserve Bank of Australia, March 2023*

The other main limitation of monetary policy is that it is a **demand management** policy – that is, it can influence aggregate demand but not the structural (or supply-side) causes of certain problems. During the inflation surge of 2022, the Reserve Bank highlighted the fact that inflationary pressures were being driven by supply-side and overseas factors – with the economy's fast recovery from the pandemic contributing to choke points in supply chains and labour shortages, while Russia's invasion of Ukraine resulted in sharp increases in food and energy prices. While higher interest rates can reduce demand pressures, they do not deal with supply-side problems, and for that reason some economists saw the steep increase in interest rates during 2022 and 2023 as excessive. Monetary policy can also struggle with conflicting goals, especially in its impact on demand and asset prices. Prior to the pandemic, the Reserve Bank noted the tension between raising interest rates in order to curb a potentially dangerous housing price bubble and wanting to encourage stronger economic growth. Monetary policy is a blunt policy instrument, and has limited effectiveness if policymakers want to support growth in one sector or region of the economy while restraining growth in another.

Monetary policy also cannot successfully address structural problems such as low productivity growth, the transition to a less carbon-intensive economy or improving external balance. In fact, even though monetary policy is intended to achieve low inflation, it can do little to address inflationary pressures other than those driven by demand from consumers and businesses. Raising interest rates to address other sources of inflation, such as a falling currency, would be attempting to solve the inflation problem by attacking something other than its real cause.

Monetary policy can also face an additional strain during periods of sustained economic growth, because it is also the tool of last resort if wages are growing too quickly. In the absence of an incomes policy that can control wage increases directly, the most effective tool to limit inflation and wage rises is tighter monetary policy. In recent times, the RBA has warned that wages growth must be accompanied by productivity improvements to ensure that wages do not contribute to inflation.

**Fiscal policy** is the most effective policy to stimulate the economy and job creation during a downturn, but it is less effective in slowing it down when the economy is overheating. Australia's fiscal responses to the COVID-19 recession in 2020 and the global financial crisis in 2008 both proved successful in immediately strengthening aggregate demand before the economy had slumped into recession. In 2009, Australia avoided recession altogether, while in 2021, although Australia could not avoid recession, it staged a quick recovery from the downturn. Fiscal policy was effective in strengthening growth on both occasions with policy packages centred on supporting household incomes but also including investment incentives, wage subsidies (in 2020), industry rescue packages, and infrastructure investment.

Like monetary policy, fiscal policy also has its limitations. Expansionary fiscal policy leads to increased budget deficits and higher public debt levels. In an environment where an economy is growing, it can draw savings away from private investment. Economists generally agree that sustained higher budget deficits over the longer term can contribute

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to higher long-term interest rates, lower national savings and an increased current account deficit. One of the longer-term concerns about the increases in public debt resulting from the COVID-19 recession is that it could take decades to pay off the debt, and higher interest rates in the future could make these debt levels a heavier burden on budgets.

> "Australia's economic recovery from the pandemic has been world leading, however to ensure Australians continue to enjoy higher living standards, we need to continue to focus on the task of lifting productivity …
>
> Given the scale and nature of the economic shock caused by the COVID-19 pandemic, it is expected to have an enduring impact on Australia's productivity challenge. The acceleration in the uptake of technology by business and individuals has stimulated growth in remote work, online commerce, businesses' digital presence and innovative delivery of public services like health and education. The pandemic has affected business models in some key sectors and underscored the need for labour mobility across the economy.
>
> In this environment, Australia needs policy settings that foster a flexible and dynamic economy, that is able to adapt in the face of economic challenges and opportunities. Policy settings should encourage the economy to adapt to the growing importance of digital technologies, including through developing a skilled labour force. They must also be forward looking and support an environment that promotes economic dynamism, entrepreneurship and appropriate risk-taking, and innovation and technological adoption."
>
> *– Productivity Commission, 5-year Productivity Inquiry: Advancing Prosperity, 2023*

In the broadest sense, the Government's **macroeconomic policy mix** was successful in sustaining 28 years of economic growth in which Australia progressively reduced unemployment, kept inflation low and enjoyed rising living standards. There was no realistic way that the policy mix could have saved the economy from recession in 2020, given the severe economic effect of lockdowns that imposed a shutdown on several sectors of economic activity. Australia recovered relatively quickly from the pandemic recession although, like other economies, macroeconomic policy then confronted a surge in inflation. The deeper problems of low productivity growth and the need to reduce the carbon intensity of the Australian economy point to the greatest limitation of macroeconomic policies – addressing structural problems.

## Microeconomic management

Australia's extensive **microeconomic reforms** since the 1980s are generally regarded as a success. Microeconomic policy has made it possible for the economy to avoid the boom/bust cycle and sustain growth, with improved living standards and reduced unemployment. The Australian economy has become more internationally competitive, and inflationary pressures have been contained. Australia's economy is generally regarded as one of the world's more open and successful economies, despite our geographic isolation from the major centres of the global economy.

Some economists have criticised the lack of ongoing microeconomic reform in the past two decades. Compared with the rapid pace of micro reform in the 1990s – when governments implemented national competition policy, enterprise bargaining, major industry deregulation, accelerated tariff cuts and the introduction of the GST – microeconomic reform has moved slowly in recent decades. To some extent, this is inevitable since many of the reforms of the 1990s involved once-off structural changes that could not be repeated. Nevertheless, the OECD and economic agencies, such as the Treasury and the Productivity Commission, have argued that more needs to be done to accelerate microeconomic reform. For example, in its 5-Year Productivity Inquiry in 2023, the Productivity Commission outlined 71 specific recommendations for policy change, many of which were microeconomic reforms. The reforms included increasing flexibility in workplace agreement making, streamlining planning and zoning laws, charging vehicles for road use, removing anti-competitive regulations on the ownership and location of pharmacies, and reforming the tax system.

For discussion of the recent conduct of monetary policy, visit the Reserve Bank website **www.rba.gov.au** and view the speeches section. In particular, look at the Hansard transcript of the Governor's parliamentary testimony given every six months (around February and August).

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Critics argue that despite Australia's relatively successful economic performance, the economy has structural weaknesses. They make the case that Australia has become too reliant on its resources exports to China and other developing economies. Productivity Commission analysis found that in the decade to 2020, Australia's labour productivity growth had slowed to the lowest rate in over 60 years. Despite improving labour market conditions, a significant number of working-age Australians remain either unemployed, underemployed or outside the labour force. Australia has lacked a clear, consistent economic policy response to climate change and has adopted expensive and often ineffective policies. Australia's ranking on competitiveness has also slipped (for example, falling from 4th in 2004 to 19th in the 2023 *World Competitiveness Yearbook*). Australia also faces significant looming challenges, including climate change, an ageing population, declining workforce participation and the risk of a sustained slowdown in China. All these factors underline the need for continued microeconomic reform, diversification of the economy and investments in education, early childhood programs and infrastructure to underpin future productivity growth.

In the longer term, the success or failure of Australia's policy mix will be measured by our capacity to restore and **sustain growth**, employment and living standards, while preparing for the far-reaching disruptive effects of climate change and water shortages, distributing the rewards of economic growth more equitably and achieving a **sustainable** position on the external accounts. The Government acknowledged the need for broader measures of the effectiveness of policy in 2023, with its "Measuring What Matters" statement. It adopted 50 indicators to measure progress across the themes of a healthy, secure, sustainable, cohesive and prosperous Australia.

The effectiveness of economic policies cannot ultimately be judged by reference to economic outcomes alone. Economic policies affect the kind of society we live in and how we lead our lives. Critical questions confront economic policymakers in the 2020s. Does an increase in GDP result in an increase in people's wellbeing and happiness? Should measures of wellbeing play a greater role in policymaking? Do we have a responsibility to future generations to act with more urgency in reducing our carbon emissions and slowing down our consumption of non-renewable resources? Is it fair that one person who grows up in a poor family has far fewer opportunities than someone who grows up in a prosperous family? Is it fair that Australians enjoy such good living standards compared to other nations when so many people are dying of easily preventable diseases in developing countries? These are more than just technical economic issues. They are choices that go to our values as a nation, and what we think is important in life – and answering these questions requires us to go beyond an economics textbook.

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## reviewquestions

1. Identify TWO major global events in recent years and explain how they have influenced Australian economic policy.
2. Describe an example of a recent government policy that illustrates the conflicts in economic policy objectives.
3. Critically analyse which economic policy instruments have been most effective in recent years in achieving their goals.

# chapter summary

1. Since the early 1990s, the main goal of the economic policy mix has been to achieve the maximum **sustainable economic growth rate** in the short to medium term (through macroeconomic policies), while implementing policies that will raise the long-term sustainable growth rate (through microeconomic policies). In overall terms, this policy mix has been reasonably successful.

2. Economic policies differ in their **implementation** time. While monetary policy decisions can be implemented immediately, major changes to fiscal policy generally take several months to plan and implement, and microeconomic policies can often take several years to implement.

3. Economic policies can differ in the **time lag** involved before they impact the economy. While fiscal policy changes such as tax cuts can have an immediate impact on the economy, monetary policy changes take up to 24 months to have their full impact and the impacts of microeconomic reforms can take many years.

4. In the short term, the main **global influences** on the Australian economy are the international business cycle, overseas interest rates, financial market conditions and commodity prices.

5. In the long term, the Australian economy is influenced by global trends in economic management. Examples include the shift away from government intervention to deregulation and privatisation in the 1980s, the adoption of inflation targeting in the 1990s, and policies to reduce carbon emissions.

6. **Political constraints** can have a significant impact on economic management, including the three-year political cycle, the unpopularity of some policies and the difficulty governments often experience in getting legislation through Parliament.

7. Effective economic management often requires governments to trade off some objectives against others and to balance **conflicting goals** such as achieving both low inflation and low unemployment.

8. The goal of achieving a **sustainable rate of economic growth** in the short term balances the objectives of inflation, growth, unemployment and external balance. The longer-term goal of raising the sustainable growth rate involves improving international competitiveness, workforce participation and productivity, and ensuring that Australia's economic growth is compatible with a fair distribution of income and wealth, and environmental outcomes.

9. **Microeconomic policy** is generally regarded as having succeeded in boosting productivity, economic growth and living standards over recent decades. However, some economists argue that Australia has not undertaken enough microeconomic reform in recent years.

10. Governments often face a **trade-off** between the goals of **equity** and **efficiency** in economic management. Inclusive growth policies aim to overcome this trade-off by simultaneously supporting growth and reducing economic inequality.

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# chapter review

1. Identify which economic objectives have had the highest priority in recent years.
2. Explain to what extent time lags affect the operation of monetary, fiscal and microeconomic policies.
3. Explain two ways in which global influences affect the conduct of economic management in Australia.
4. Discuss how a major downturn in the global economy might affect the key economic indicators in Australia.
5. Explain how political constraints can influence economic policymaking.
6. Evaluate the effectiveness of Australia's economic policy mix in sustaining economic growth and low inflation during the past decade.
7. Identify a policy objective that has been achieved during recent years and explain the factors contributing to that success.
8. Discuss the relationship between economic growth and increased inequality in the distribution of income and wealth.
9. Evaluate the extent to which economic management in Australia has been successful in recent years compared with preceding decades. Analyse the extent to which this is the result of global or domestic factors.
10. Critically evaluate the extent to which equity and environmental outcomes have been sacrificed to achieve other economic objectives in recent years.

SAMPLE PAGES