

# **QCE Unit 4 Topic 3: Economic Management**

*Fiscal Policy, Monetary Policy & Supply-Side Policies*

*Comprehensive Study Guide with 20 Multiple Choice Questions*

## **SECTION 0: ECONOMIC POLICY RATIONALE & FRAMEWORKS**

### **0.1 Why Governments Intervene in the Economy**

- Market failures: Monopolies, externalities, information asymmetries → government must correct
- Macroeconomic objectives: Growth, employment, inflation, external stability, living standards
- Efficiency: Ensure resources allocated optimally (avoid waste, unemployment)
- Equity: Redistribute income/wealth to reduce inequality (progressive tax, welfare)
- Stabilization: Smooth economic cycle (reduce booms/busts)

### **0.2 Three Pillars of Economic Policy**

- Demand Management: Control total spending (AD) to influence growth, employment, inflation
- Supply-Side Policies: Improve productive capacity (LRAS), competitiveness, efficiency
- Microeconomic Reforms: Remove barriers, improve competition, enhance productivity

### **0.3 Policy Trade-offs: Efficiency vs. Equity**

- Higher taxes on rich → more equal but less incentive to work/invest (efficiency cost)
- Deregulation → more competition, lower prices (efficiency) but may harm workers (equity)
- Welfare spending → reduces inequality but creates work disincentives (moral hazard)
- Government must balance both; no perfect solution

### **0.4 Policy Constraints & Limitations**

- Time lags: Implementation delay (6–18 months); recognition delay (data arrives late)
- Global influences: International trade, capital flows, foreign interest rates affect Australia

- Political constraints: Election cycles (5 years max); budget cycle; ideological differences
- Structural deficits: Long-term fiscal imbalances may limit policy room

## **SECTION A: FISCAL POLICY (DEMAND MANAGEMENT)**

### **A.1 Sources of Government Revenue**

- Direct taxes: Income tax, company tax, capital gains tax, superannuation tax (withheld from income)
- Indirect taxes: GST, excise duty, customs duty, payroll tax (added to prices)
- Other sources: User fees, government asset sales, borrowing (deficit financing)

### **A.2 Tax Classification: Progressive, Proportional, Regressive**

- Progressive: Rate rises with income (e.g., 19% on \$20k → 45% on \$200k) → reduces inequality
- Proportional: Same % for all income levels (e.g., flat 20% tax) → neutral on distribution
- Regressive: Rate falls as income rises (e.g., GST = 10% on all spending) → increases inequality
- Australia's income tax: Progressive (19% → 45%); GST regressive (10% on all goods)

### **A.3 Government Expenditure Components**

- Current spending: Salaries, goods/services consumed this year (e.g., welfare, defence salaries)
- Capital spending: Infrastructure investment (roads, schools) that yields benefits over years
- Transfer payments: Welfare, pensions, unemployment benefits (redistribution, no new production)
- Public utilities: Government-owned services (water, electricity) sold at cost
- Merit goods: Education, health (underconsumed by private market; government subsidizes)

### **A.4 How Fiscal Policy Works: Transmission Mechanism**

- Expansionary ( $\uparrow G$  or  $\downarrow T$ ): Increases disposable income → consumption rises → AD rises → Y, employment rise
- Lag: Takes 6–12 months for full effect (people adjust behaviour slowly)
- Multiplier: Total AD change = initial injection × multiplier (1.5–2.5 in Australia)
- Crowding out: If government borrows heavily, interest rates rise → private investment falls (offset)

- Contractionary ( $\downarrow G$  or  $\uparrow T$ ): Reduces disposable income  $\rightarrow$  consumption falls  $\rightarrow$  AD falls  $\rightarrow Y$ , employment fall

### A.5 Automatic Stabilisers vs. Discretionary Policy

- Automatic stabilisers: Tax/welfare adjust automatically with cycle (no government decision needed)
- In recession: Tax revenue falls, welfare rises  $\rightarrow$  built-in support cushions shock
- In boom: Tax revenue rises, welfare falls  $\rightarrow$  built-in restraint prevents overheat
- Discretionary: Government actively changes spending/taxes (e.g., announcing stimulus package)
- Trade-off: Automatic good for stability but slow; discretionary faster but needs political will

### A.6 Effectiveness & Limitations of Fiscal Policy

- Strengths: Can target specific groups; politically popular (spending up or taxes down)
- Weaknesses: Long time lags; crowding out (high govt. borrowing  $\rightarrow$  interest rates rise)
- Structural deficit problem: If deficit becomes structural (permanent), limits future policy room
- Global influences: Large fiscal expansion may cause current account deficit, exchange rate pressure
- Political constraints: Election cycles mean policy may not time well with cycle

## SECTION B: MONETARY POLICY (DEMAND MANAGEMENT)

### B.1 The Reserve Bank of Australia (RBA): Role & Objectives

- Central bank of Australia; controls money supply & official cash rate
- Statutory objectives (RBA Charter):
  - 1. Price stability (inflation 2–3% target over the cycle)
  - 2. Full employment (maximum sustainable employment)
  - 3. Economic prosperity & wellbeing of Australian people
- Independent from government (political insulation for credibility)

### B.2 Inflation Targeting: The 2–3% Target

- Target range: 2–3% over the medium term (not hitting it every quarter)

- Rationale: Low enough to avoid deflation/wage-price spirals; high enough to avoid deflation trap
- Credibility: If expectations anchored at 2–3%, easier to control actual inflation
- Transmission: RBA controls cash rate, which influences all other interest rates
- Time horizon: Effects take 12–18 months to fully flow through (long lags)

### B.3 Monetary Policy Transmission Mechanism (How Rate Changes Affect Economy)

- 1. Policy rate: RBA raises/lowers official cash rate directly (e.g., 0.1% → 4.35%)
  2. Bank rates: Commercial banks adjust mortgage, savings, business lending rates
  3. Asset prices: Higher rates → bond yields rise, share prices fall (wealth effect negative)
  4. Consumption: Higher mortgage rates reduce disposable income → consumption falls
  5. Investment: Higher borrowing costs reduce hurdle rates for projects → investment falls
  6. Exchange rate: Higher rates attract foreign capital → AUD appreciates → exports less competitive
  7. Aggregate demand: C + I fall, X falls (X–M worsens) → AD falls → Y, inflation fall

### B.4 Basis Points vs. Percentage Points (Critical Terminology)

- 1 basis point (bp) = 0.01 percentage points (pp)
- RBA raised rates 425bp = raised by 4.25 percentage points (0.1% → 4.35%)
- 'Rates fell 25bp' = fell by 0.25pp
- Why precision matters: Market sensitivity to small moves; 0.25pp matters for billions in payments

### B.5 Types of Monetary Policy Stances

- Expansionary (Loose): Lower rates, increase money supply → stimulate AD

- Contractionary (Tight): Raise rates, decrease money supply → dampen inflation
- Neutral: Rate consistent with inflation at target, output at potential → no additional stimulus/restraint

### **B.6 Limitations of Monetary Policy**

- Zero lower bound (ZLB): Can't push rates below 0% (time spent near ZLB 2008–2010, 2020–2021)
- Liquidity trap: At very low rates, extra money doesn't stimulate (people hoard cash)
- Time lags: 12–18 months before full effect (long period of uncertainty)
- Global influences: International rates, capital flows, commodity prices affect Australia
- Asset bubble risk: Very low rates for long time may inflate housing/equity bubbles
- Political pressure: Government may push for lower rates for electoral advantage

### **B.7 Monetary Policy During Different Cycle Phases**

- Expansion: RBA keeps rates steady or raises gradually (prevent overheat)
- Peak/Overheating: RBA raises rates sharply (cool inflation, accept higher unemployment short-term)
- Contraction: RBA cuts rates sharply (support growth, accept lower inflation short-term)
- Trough: RBA may keep rates low or gradually raise (support recovery without overstimulating)

## **SECTION C: SUPPLY-SIDE & MICROECONOMIC POLICIES**

### **C.1 What Are Supply-Side Policies?**

- Aim: Improve productive capacity (LRAS), not just manage demand
- Time horizon: Long-term (5–10+ years) vs. demand management (short-term 1–2 years)
- Mechanism: Increase efficiency, productivity, competitiveness → shift LRAS rightward → growth without inflation
- Advantage: Can achieve growth without inflation (demand management creates trade-off)
- Disadvantage: Slow; results take years; structural reforms often politically unpopular

### **C.2 Types of Supply-Side Policies**

- Infrastructure: Roads, railways, ports, broadband (lower business costs, improve efficiency)

- Education & training: Schools, vocational, universities (skilled workforce, human capital)
- Research & development: Government funding, tax incentives (innovation, productivity)
- Deregulation: Remove licensing barriers, reduce compliance costs (increase competition, efficiency)
- Labour market reforms: Reduce job protection, increase flexibility (adapt to shocks, allocative efficiency)

### **C.3 Infrastructure Investment**

- Types: Transport (roads, rail), energy, water, digital (broadband, 5G)
- Benefits: Reduces business costs (faster transport), increases productivity (better communication)
- RoI: Public infrastructure often has lower returns than private; justification is positive externalities
- Timing: Countercyclical (build during recessions when resources idle) most efficient
- Australia examples: NBN (broadband), Melbourne metro expansion, ports upgrade

### **C.4 Education & Skills Training**

- Primary/secondary: Builds foundational skills, improves workforce quality (long-term effect)
- Vocational (VET): Technical skills for immediate workforce needs (plumbers, electricians shortage)
- University: Develops professional workforce (doctors, engineers, economists)
- Upskilling: Retraining for displaced workers (manufacturing decline, coal transition)
- Return: Individuals earn 5–10% more per year; society gains from higher productivity

### **C.5 Research & Development (R&D)**

- Government role: Direct funding (universities, CSIRO); tax incentives (R&D tax credit)
- Benefits: New technologies, productivity gains, competitive advantage in global markets
- Market failure: Firms underinvest in R&D (benefits spill over to competitors); government needed
- Spillover: Basic research (universities) → applied innovation (business) → productivity growth
- Australia: Allocates ~2% of budget to R&D (below OECD average 2.4%)

## C.6 Deregulation & Competition

- Aim: Remove barriers to entry, reduce compliance costs, increase competition
- Benefits: Lower prices (competition), better service (pressure to improve), innovation
- Costs: Potential job losses (firms cut costs); safety concerns; inequality (winners/losers)
- Examples: Airline deregulation (cheap flights), telecommunications (fixed-line → mobile), taxi/rideshare
- Trade-off: Efficiency gains vs. distributional equity impacts

## C.7 Productivity vs. Demand Management

- Demand management (fiscal/monetary): Quick effect on employment/growth; no inflation cost if spare capacity
- Supply-side: No short-term growth boost; but sustainable, no inflation trade-off in long-run
- Australia's challenge: Need both (weak demand + low productivity growth)
- Fiscal expansion + productivity reforms = optimal medium-term mix

## MULTIPLE CHOICE QUESTIONS

20 Questions Covering Unit 4 Topic 3 Content

### Question 1

Australia's income tax system is progressive (19% on \$20k income → 45% on \$200k income). Why is this system chosen?

- A. To maximize tax revenue by charging all taxpayers the same rate
- B. To improve equity by reducing income inequality while funding government services
- C. To encourage work and investment by taxing low earners more heavily
- D. Because it is the only type of tax system that governments can implement

### Question 2

Which of the following best explains how automatic stabilisers reduce the need for discretionary fiscal policy?

- A. They fix interest rates, preventing policy lags
- B. Tax revenue falls and welfare rises automatically in recessions, providing built-in stimulus
- C. They eliminate the business cycle entirely
- D. They reduce the size of government permanently

### Question 3

Transfer payments (welfare, pensions) differ from current government spending on goods/services because:

- A. Transfer payments create no new production; they redistribute existing income
- B. Transfer payments are more expensive than government spending
- C. Transfer payments are never included in the government budget
- D. Transfer payments automatically eliminate poverty

### Question 4

In 2020, the Australian government increased spending on JobKeeper and cash transfers. Through the transmission mechanism, how would this affect aggregate demand?

- A. Increased disposable income → consumption rises → AD rises → Y and employment increase

- B. Increased spending → automatic stabilisers kick in → unemployment automatically falls
- C. Government spending crowds out private investment immediately
- D. Fiscal stimulus has no effect on AD during a pandemic

### Question 5

Which is a limitation of using fiscal policy to manage the economic cycle?

- A. Fiscal policy is too powerful and cannot be controlled
- B. Recognition lags (data arrives late) and implementation lags (changes take time) delay effects
- C. Fiscal policy never works on aggregate demand
- D. Structural deficits guarantee inflation regardless of fiscal stance

### Question 6

The Reserve Bank of Australia's statutory objective is to achieve an inflation rate of 2–3% 'over the medium term'. Why not target 0% inflation or negative inflation?

- A. To avoid deflation trap and wage-price spirals; allow room for individual price adjustments
- B. Because 0% inflation is mathematically impossible
- C. Because 2–3% inflation is best for all countries regardless of circumstances
- D. Because the RBA cannot control inflation below 2%

### Question 7

When the RBA raised the cash rate from 0.1% to 4.35% (2022–2023, 425bp), the primary transmission mechanism would be:

- A. Consumers immediately stop spending; GDP falls instantly
- B. Mortgage rates rise → disposable income falls → consumption falls → AD falls → inflation falls (with lag)
- C. Government spending decreases automatically
- D. The exchange rate depreciates, boosting exports immediately

### Question 8

Which situation describes the 'zero lower bound' problem in monetary policy?

- A. Interest rates cannot go below 0%, so when at 0%, cutting rates further is impossible
- B. Banks refuse to lend when rates are zero
- C. Zero inflation is impossible to achieve
- D. Interest rates are always zero in recessions

### Question 9

Supply-side policies differ from demand management policies in that they:

- A. Work faster (1–3 months vs. 12–18 months for demand management)
- B. Aim to shift LRAS rightward (increase productive capacity) rather than move along AS
- C. Have no limits on effectiveness
- D. Eliminate the need for any demand management

### Question 10

Which of the following best illustrates how infrastructure investment (e.g., NBN broadband) acts as a supply-side policy?

- A. NBN reduces business costs → productivity rises → LRAS shifts right → growth without inflation
- B. NBN spending immediately increases AD → unemployment falls → inflation rises
- C. NBN investment guarantees full employment regardless of demand conditions
- D. NBN has no impact on the productive capacity of the economy

### Question 11

Education and vocational training are supply-side policies because they:

- A. Immediately reduce unemployment in the short term
- B. Increase human capital and workforce productivity → LRAS expansion → long-term growth
- C. Replace the need for monetary policy
- D. Cause inflation to rise immediately

### Question 12

A key market failure justifying government R&D funding is that:

- A. Private firms always invest too much in research
- B. Benefits of basic research spill over to competitors, so firms underinvest; government funds fills gap
- C. All research must be done by government, never by private companies
- D. R&D never contributes to productivity growth

### Question 13

Deregulation (e.g., airline industry) is a supply-side policy that improves efficiency by:

- A. Increasing government control of industry
- B. Removing barriers to entry → competition increases → prices fall, service improves, innovation rises
- C. Guaranteeing that no workers will be displaced
- D. Having no distributional equity impacts

#### Question 14

A key trade-off between fiscal expansion and supply-side reform is:

- A. Fiscal policy has immediate effect but risks inflation; supply-side is slow but sustainable
- B. Supply-side policies are faster than fiscal policy
- C. There is no trade-off; both are equally effective at all times
- D. Fiscal policy cannot achieve growth without supply-side policies

#### Question 15

Australia's RBA has a 'flexible inflation targeting' framework. This means:

- A. The RBA ignores employment and focuses only on inflation
- B. RBA can deviate from 2–3% target temporarily to manage other objectives (employment, financial stability)
- C. There is no actual inflation target
- D. The RBA must hit 2–3% inflation every single month

#### Question 16

Which policy response would be most effective if Australia faced BOTH low growth AND low inflation?

- A. Fiscal expansion alone (growth risk, inflation not a concern)
- B. Monetary tightening (would worsen both problems)
- C. Combined fiscal expansion + supply-side reforms (demand boost + long-term growth)
- D. Do nothing (economy will self-correct)

#### Question 17

Merit goods (education, health) justify government provision because:

- A. They are consumed by wealthy people only
- B. Market underinvestment occurs due to positive externalities; society benefits more than private consumers
- C. They are always more expensive in public sector than private
- D. Government always provides these services more efficiently

### Question 18

Why does the RBA maintain independence from direct government control?

- A. So politicians cannot pressure it for short-term rate cuts before elections (credibility)
- B. Because the government is always wrong about economic policy
- C. To eliminate the need for fiscal policy
- D. To prevent inflation targeting

### Question 19

The 'crowding out' effect of fiscal policy occurs when:

- A. Government spending increases consumption automatically
- B. Government borrows heavily → interest rates rise → private investment falls (partial offset)
- C. Government always crowds out the private sector completely
- D. Fiscal policy has no effect on interest rates

### Question 20

If a government implemented both significant fiscal expansion AND large supply-side productivity reforms simultaneously, the most likely outcome would be:

- A. Economic growth with temporary inflation risk in short-term, sustainable growth long-term
- B. Immediate collapse of the economy
- C. No growth whatsoever (policies cancel each other)
- D. Stagflation with no possibility of improvement

## MARKING GUIDE

### *Answer Key & Explanations*

Q1: B | Q2: B | Q3: A | Q4: A | Q5: B | Q6: A | Q7: B | Q8: A | Q9: B | Q10: A  
Q11: B | Q12: B | Q13: B | Q14: A | Q15: B | Q16: C | Q17: B | Q18: A | Q19: B | Q20: A

### Detailed Explanations

Q1 (B): Progressive taxation reduces inequality while funding services. Efficiency cost exists but accepted for equity.

Q2 (B): Built-in cushions don't need active decision; contrast with discretionary stimulus.

Q3 (A): Key distinction: transfers redistribute; spending creates production.

Q4 (A): Classic transmission mechanism:  $\uparrow G/\uparrow T \rightarrow \uparrow \text{disposable income} \rightarrow \uparrow C \rightarrow \uparrow AD$

Q5 (B): Time lags (6–18 months) are main limitation, not effectiveness.

Q6 (A): Deflation trap risk; 2–3% allows some inflation without instability.

Q7 (B): Transmission slow (12–18 months); mortgage effects crucial.

Q8 (A): Cannot push rates below 0%; liquidity trap at ZLB.

Q9 (B): Supply-side shifts LRAS; demand management moves along AS.

Q10 (A): Lower costs = productivity = rightward LRAS shift.

Q11 (B): Human capital expansion shifts LRAS long-term.

Q12 (B): Spillover effects justify government funding.

Q13 (B): Competition mechanism improves efficiency; but equity costs exist.

Q14 (A): Trade-off: speed vs. sustainability.

Q15 (B): Flexible means can deviate temporarily.

Q16 (C): Combined approach addresses both demand & supply.

Q17 (B): Positive externalities justify intervention.

Q18 (A): Central banker independence prevents political pressure.

Q19 (B): Borrowing  $\rightarrow$  interest rates  $\rightarrow$  investment falls (partial offset).

Q20 (A): Both policies work together: short-term demand, long-term capacity.