

## Supply management policies



Read pages 277–292 of the textbook.

### Introduction

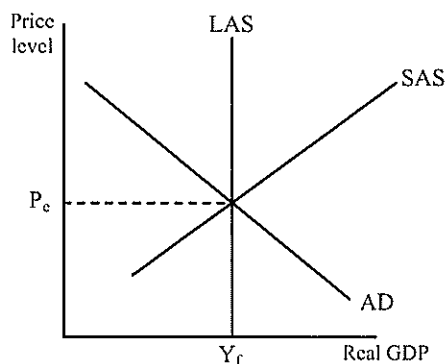
Fiscal and monetary policy are macroeconomic in nature, that is they aim to influence the economy as a whole. Supply management policies (also known as microeconomic reform or structural policy), however, are microeconomic in nature. This is because they refer to a range of measures that aim to change certain parts of the economy or particular industries so that they become more productive and efficient. They aim to increase productivity by cutting costs, promoting competition and restructuring the way production is organised. This involves allocating resources more efficiently so that more output can be gained from the same quantity of resources. They are aimed at influencing aggregate supply rather than aggregate demand.

Both fiscal and monetary policies are aimed at influencing aggregate demand. The problem with influencing aggregate demand is that objectives may conflict. For example, if aggregate demand is increased to generate growth and employment, it is likely that inflation will occur. If aggregate demand is decreased to reduce inflation, then growth will slow and unemployment may result. In each case, progress is made towards achieving one or two economic objectives, but at the cost of another objective worsening.

Supply management policies aim to overcome these drawbacks by increasing long-run aggregate supply and achieving all economic objectives together, in the long run.

### Activity 1

Show an increase in long run aggregate supply on the diagram below and explain the effect on the economic objectives of price stability, full employment and economic growth.



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**The need for supply management policies**

Prior to the 1990s Australia’s productivity and overall economic performance were declining rapidly, relative to the rest of the world. In terms of living standards, Australia fell from fourth in 1950 to fifteenth in the early 1990s, according to OECD rankings.

The economy was handicapped by structural weaknesses and highly regulated markets. Some of the reasons why Australia’s economic performance had declined against the rest of the world were:

- high levels of protective tariffs
- centralised wage fixing
- government ownership of infrastructure
- a narrow trade base
- outdated technology and work practices.

As a result productivity growth was low, causing low growth in average incomes. Living standards declined relative to the rest of the world.

Country	Income*			Productivity*		
	1970-80	1980-90	1990-2000	1970-80	1980-90	1990-2000
United States	2.1	2.2	2.2	0.8	1.4	1.9
Japan	3.3	3.5	1.1	3.6	2.8	1.0
France	2.7	1.8	1.4	2.7	2.1	1.3
United Kingdom	1.8	2.5	1.9	1.7	2.0	2.0
Canada	2.8	1.5	1.7	0.8	1.1	1.4
Australia	1.5	1.7	2.3	1.7	1.0	2.1
OECD average	2.4	2.2	1.8	1.9	1.7	1.6

\*Income = GDP per capita, annual % change. \* Productivity = GDP per person employed, annual % change

Source: OECD <http://www.oecd.org/home/>

The table shows how Australia compared to the main economies in the world and the OECD average for income growth and productivity over the last three decades.

(Productivity is a measure of output per unit of resources. It can be measured in a number of ways including GDP per person employed and GDP per hours worked.)

**Activity 2**

1. Compare Australia’s income growth and productivity with the other countries and the OECD average for the periods shown in the table.

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2. Give some reasons for the changes you have noted.

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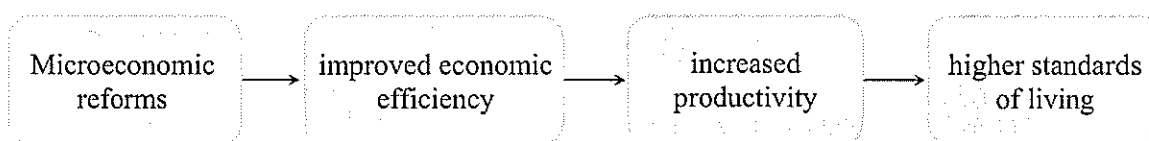
### Aims of supply management policies

The main aim of microeconomic reform is to improve the efficiency of resource allocation. This includes:

- Allocative efficiency: ensuring resources are directed to areas where they are best suited so that more output can be produced to meet more of society's needs and wants. Often this happens when competition in the market is encouraged.
- Productive efficiency: encouraging businesses to lower costs by using more efficient production methods.
- Dynamic efficiency: encouraging firms to become innovative, use the latest technology, update employee skills, promote product development and in general become more flexible to be able to respond to changing economic circumstances.
- Inter-temporal efficiency: ensuring that there is a balance between resources allocated to current consumption and for future investment.

Improved efficiency leads to increases in productivity and ultimately higher standards of living because:

- increased productivity increases the economy's rate of economic growth and therefore leads to more employment
- increased efficiency helps to cut costs and lower inflation, leading to improved competitiveness and more sales and therefore more employment
- there will be higher incomes and therefore greater access to goods and services for consumers
- lower production costs and greater efficiency lead to increased international competitiveness, causing an increase in exports and improving the CAD and foreign debt
- more taxation revenue is generated for the government, providing more funds for the welfare system and provision of community services.



### Specific areas of supply management policies

Supply management policies involve a range of measures across a number of different areas including:

1. tariff and protection reduction
2. competition
3. labour market reforms
4. deregulation of industries
5. reform of the public sector
6. taxation reform.

1. **Tariff and protection reduction**

In the past, the government has used a range of measures to protect local industries from overseas competition, including subsidies, quotas and most commonly, tariffs. (Note: These are all discussed in detail later in the course.) However, by the early 1980s, it was clear that high levels of protection had encouraged resources to be allocated to inefficient uses, meaning that consumers must pay higher prices than necessary. Also, large parts of Australian manufacturing were recognised as seriously lacking in international competitiveness and in urgent need of restructuring to promote innovation, modernisation and efficiency.

Microeconomic reform in this area has been to reduce the rate of protection to promote greater competition in domestic markets and expose local businesses to international competition. The aim is to encourage resources to be allocated to areas of production where Australia has a comparative advantage. By putting resources to work in their most productive use overall production should be maximised and living standards improved.

**Activity 3**

The table below shows effective rates of tariff assistance (in %) to various manufacturing areas in selected years:

Industry	1974-75	1977-78	1983-84	1989-90	1996-97	2000-01
Food, beverages and tobacco	22	10	6	5	4	5
Textiles, clothing and footwear	66	88	143	86	32	23
Wood and paper products	21	19	22	14	6	6
Printing and publishing	22	23	13	7	1	1
Motor vehicles	53	70	131	55	21	14
Machinery and equipment	25	19	22	20	3	2
Total manufacturing	27	23	23	16	6	5

Source: Productivity Commission, Trade Assistance Review. [www.pc.gov.au](http://www.pc.gov.au)

1. Describe the changes in protection for:

(a) total manufacturing

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(b) textiles, clothing and footwear

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(c) motor vehicles

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2. Which two industries receive the highest rate of assistance? Why do you think this is the case?

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3. (a) Why has the government adopted a policy of reducing protection?

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(b) Do you think that tariff reduction is a successful economic reform from the point of view of those involved in the car manufacturing industry? Explain your answer.

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## 2. Competition

Competition encourages firms to be more efficient and productive so they can keep their costs and prices down as low as possible. It also means that businesses must innovate, use better work practices and invest in the latest technology so they can provide customers with what they want and therefore maintain market share.

The Australian governments' National Competition Policy is aimed at facilitating competition to reform government business enterprises (GBEs) and improve the performance of infrastructure industries. Infrastructure refers to the basic facilities, services, and installations needed for the functioning of society, such as transportation and communications systems, water and power lines, and public institutions including schools, post offices, and prisons. These industries provide essential services to businesses as well as households, so improving their efficiency helps to improve the productivity of a range of industries.

As part of competition policy, the government set up the Australian Competition and Consumer Commission (ACCC) to administer the *Trade Practices Act*. The *Trade Practices Act* aims to prevent anti-competitive behaviour from powerful companies that causes increased prices and exploits consumers. The Act makes a number of restrictive trade practices illegal (these were discussed in detail back in week 8).

In addition, the ACCC has several other functions. It investigates proposed mergers and takeovers and can disallow them if they are found to be against the public interest. It also investigates price rises by both private and public enterprises where there is less competition to see whether those price rises are justified. For example, the ACCC has examined petrol companies, banks communications and electricity providers in the past. While the ACCC has no power to prevent price rises, if a business proceeds against the Commission's judgement they are likely to suffer adverse publicity in the media.

**Activity 4**

1. Why is increased competition seen as an important economic reform?

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2. Explain why reform of infrastructure is important for overall improvements in productivity.

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3. (a) Distinguish between a merger and a takeover. Give an example if possible.

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(b) Explain how a merger or takeover might be against the public interest.

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**3. Labour market reforms**

Australia's labour market has been targeted as a key area of structural adjustment as low levels of labour productivity and high costs have hindered our international competitiveness. Improvements in the labour market are seen as vital in determining Australia's productive capacity, economic growth, ability to adapt to changing circumstances and international competitiveness.

The government has introduced a range of reforms to improve the functioning of the labour market. The aim is to:

- increase labour productivity
- improve flexibility in the supply of labour
- improve the skills of the labour force
- control costs.

The *Workplace Relations Act* was introduced by the Australian government to reform and deregulate the labour market. This Act:

- reduced the responsibilities of the AIRC
- simplified the award system
- reduced the role of trade unions by making compulsory unionism illegal
- relaxed unfair dismissal provisions
- contains anti-discrimination provisions and supports equal pay
- emphasises enterprise bargaining for negotiating wage rises
- allows individual Australian Workplace Agreements (AWAs).

One of the most important reforms has been the move away from centralised wage fixing and towards deregulated wages based on workplace agreements. Traditionally, Australia has relied on a centralised wage fixing system where the Australian Industrial Relations Commission (AIRC) set minimum award wages for workers across Australia. While this system still exists, it is now limited to a 'safety net' for low-paid workers who are unable to negotiate individual contracts.

The majority of workers are now covered by enterprise agreements (also called workplace agreements). These are negotiated directly between the workers and their employers on a firm by firm basis. This allows businesses greater flexibility in setting wages to better reflect worker performance and the financial circumstances of the firm. Wage rises are based on improvements in labour efficiency and productivity and are renegotiated regularly.

Other labour market reforms:

- introducing competency-based vocational education and training to increase skills of workers
- training and employment schemes to improve the skills of workers, for example Work for the Dole Scheme
- replacing the Commonwealth Employment Service with private employment placement providers.

**Activity 5**

1. Explain why labour market reforms are important.

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2. Explain how enterprise agreements improve the productivity of the labour force.

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### 4. Deregulation of industries

Government has a responsibility to regulate industry to ensure it meets the needs of consumers, producers and society as a whole. However, regulation interferes with the market mechanism, resulting in the misallocation of resources and encouraging inefficiencies. By the 1980s and 90s there was a growing belief that government involvement in industry should be scaled back to allow markets to function more effectively.

Deregulation involves removing or reducing rules and regulations that restrict competition or encourage the inefficient use of resources. The aim is to extend competition and encourage more efficient firms and industries by using market forces. Inefficient industries will decrease and possibly disappear. Deregulation occurred in a number of Australian markets in the 1980s and 90s. Some examples are given below.

#### **Airlines**

The government's two-airline policy for domestic flights was abolished in 1990. This allowed more competition from new carriers such as Compass and later Virgin Blue. Qantas was also allowed to fly domestic routes, while Ansett started overseas flights. Australian Airlines merged with Qantas to gain economies of scale and in 1996 Qantas was privatised. In 2001 Ansett closed down due to poor profitability and declining market share.

These changes brought about intense price competition and average fares fell as a result. Passenger numbers and employment in the industry both increased significantly.

#### **Telecommunications**

Telstra's monopoly was abolished in 1992, allowing for competition from new carriers such as Optus, AAPT and Vodafone. Telstra was partly privatised, with plans to fully privatise later. The result of the extra competition was an improvement in Telstra's efficiency, profitability and services. Prices fell, particularly on mobile and overseas calls. There was a large fall in employment at Telstra, but this was partly offset by increased new employment in the new carriers.

#### **The financial system**

Deregulation of the financial sector began in 1983 with the floating of the Australian dollar and the reduction of controls on the entry of new banks. This exposed local banks to more competition from foreign banks. In addition, restrictions on banks were removed allowing them to compete with non-bank financial institutions. The Commonwealth Bank, which was owned by the government, was privatised and some building societies converted to banks, adding to the competition.

The result of these reforms has been lower interest rates for borrowers and a wider range of services, such as Internet banking. However, there has also been a rise in bank charges and the closure of some bank branches.



**5. Reform of the public sector**

Government Business Enterprises (GBEs) play an important role in the economy, providing key inputs for the private sector such as telecommunications, railways and airports at a federal level, and power and water at a state level. However, government businesses that had no competition and which were financed by government revenue had less incentive to use resources efficiently or to ensure their products were competitive in price and quality. Reforms of the public sector therefore have involved a number of measures designed to increase competition and improve the efficiency of service delivery including privatisation, corporatisation and the National Competition Council.

- National Competition Council (NCC)

The National Competition Council is an organisation that provides advice on and evaluates state government microeconomic reforms. This is part of the government's competition policy and aims to break down public sector monopolies and remove advantages that GBEs had over the private sector. For example the NCC scrutinised the creation of a national electricity grid and water supplies.

- Privatisation

Explain what is meant by privatisation. Give some examples.

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Why has government privatised some GBEs?

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- Corporatisation

Explain what is meant by corporatisation. Give some examples.

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**6. Taxation reform**

By the 1990s there were a number of problems with Australia's tax system including:

- A narrow tax base which meant the government relied heavily on income tax and taxes on a limited range of goods to raise revenue.
- The tax burden on individuals and companies was too heavy, discouraging personal effort and weakening the international competitiveness of businesses.
- The tax system encouraged consumption rather than saving and discouraged work and the earning of income.
- The tax system encouraged tax evasion and minimisation through the cash and black market economies, understating or not disclosing income or overstating deductions.
- The tax system as a whole was complex and inefficient.

From 2000 the government introduced a number of measures to reform the tax system. They aim to increase economic incentive, lower production costs, create a better environment for business investment and make the distribution of personal income more equitable. The reforms included:

- The introduction of a goods and services tax (GST) at 10%. The GST broadens the tax base and replaces the old wholesale tax which was inefficient.
- The rate of the Capital Gains Tax (CGT) was halved. CGT applies to the sale of capital assets. The rate was reduced to encourage business investment.
- The rate of company tax was reduced so that businesses could be more competitive and to reduce tax avoidance. Also government businesses were required to pay company tax to remove their competitive bias.
- Personal income tax thresholds for the two top marginal tax rates were increased so that workers could earn more before paying the top tax rates. This provides an economic incentive to work harder.
- Tax concessions were offered to certain industries for research and development and investment.

**Activity 6**

1. Explain how these tax reforms are expected to increase productivity.

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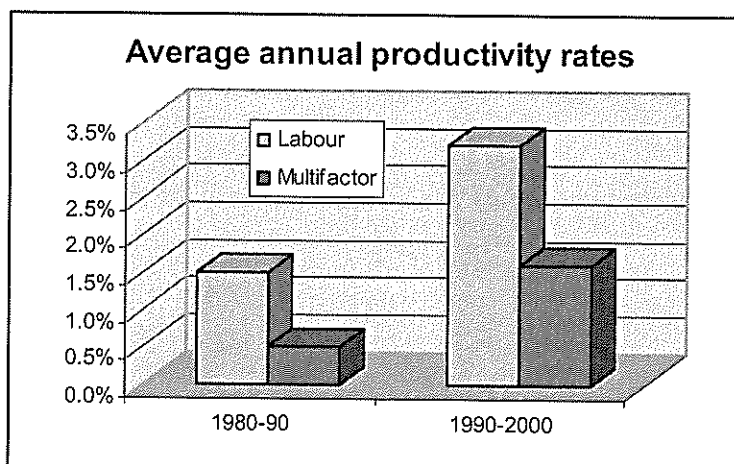
2. Explain how these tax reforms might reduce tax evasion.

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## An evaluation of microeconomic reform

### Benefits of microeconomic reform

- Microeconomic reforms have resulted in significant improvements in Australia's productivity as shown in the graph below.



Source: ABS, [www.abs.gov.au](http://www.abs.gov.au)

\*Multifactor productivity is a measure of output produced by all resources. It is estimated by dividing output by labour and capital inputs combined.

- Improved productivity and efficiency lead to long-term gains of increased output, employment, economic growth and ultimately an improvement in living standards.
- Microeconomic reforms have proven to be the most effective way of reducing cost-push inflation as improved efficiency means lower costs of production for firms.
- Other benefits include improved quality and service, greater choice and better value products.
- Competition drives firms to improve other aspects of their business including more innovation, better management and work practices, and increased research and development. Also, firms are now more flexible and able to adapt to changing circumstances.

### Costs of microeconomic reform

Increase in **structural unemployment**. One of the major problems of microeconomic reform has been increased structural unemployment in the short term. This is because:

- Businesses shed labour to become more efficient, or close down because they no longer can compete. For example, deregulation and the consequent restructuring in the airline and telecommunication industries resulted in more productivity but also higher unemployment when Ansett Airlines and One-Tel collapsed.
- Reductions in tariffs have resulted in many businesses closing and increased unemployment in the textile, clothing and footwear industry.
- Privatisation and corporatisation of GBEs have also caused unemployment.

Another problem is inequity **in the distribution of income**. Some workers will gain higher wage rises than other workers. Some will suffer lower incomes. This is because:

- Microeconomic reform has not occurred in all firms, industries and regions at the same pace. Those areas which have achieved rises in efficiencies have had the highest growth in incomes. Those areas where productivity increases have been slow, however, find that their share of income is less relative to others.

- Reforms that cause structural unemployment usually mean a large decrease in incomes for those unemployed. Increased unemployment in certain sectors such as aviation and telecommunication, for example, means that the costs of microeconomic reform were concentrated on people involved in those industries, even though the benefits are shared by the whole community.
- Reforms in the labour market have also decreased the power of some unions to protect workers and negotiate wage rises, further contributing to inequity in income.
- Structural change has brought about an increase in casual and part-time work (see week 9) and a loss in full-time work and job-security.

Rapid reform can generate **uncertainty** and increased stress at the prospect of change for many workers.

### Conclusion

In the long term, it is likely that microeconomic reform will generate higher economic growth and living standards for all. In the short term, however, there may be so called 'transitional costs' such as higher unemployment and greater inequities in the distribution of income. This provides a challenge for governments to use the welfare system and industry assistance to minimise social disruption and ensure that all have access to basic goods and services.

### Activity 7

Read the article below and answer the questions that follow.

## Farmers milked by deregulation

Deregulation was devastating dairy farmers and their communities once protected by price subsidies and quotas, a report has found.

Dairy farmers in Victoria, who produce two-thirds of the nation's milk, are benefiting from their competitive advantage from earlier restructuring to seize a bigger slice of the market. But Queensland and NSW farmers, who relied on quotas before they were abolished in July 2000, were suffering, losing an estimated \$170m a year. They had suffered a 30% cut in milk prices, while Victorian farmers only faced a 3% fall.

The report also found that in the six months since deregulation 200 dairy farmers had left their farms and that 30 per cent of farmers would leave in the

next five years. A spokesman for the Australian Milk Producers' Association claimed that this would have a huge impact on regional economies and entire communities.

Before deregulation, dairy farmers were contracted to supply milk to one processor in their own state and the price they'd get was guaranteed, regulated by government. Deregulation means that farmers now get what processors are prepared to pay on the open market and they are competing against those in other States to sell their product.

The report found that the average price for a litre of milk was slightly lower, despite a levy of 11c a litre used to help fund a federal government \$1.8b package for dairy farmers to help them through deregulation.

1. Explain how subsidies and quotas would have protected the milk market.

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2. Outline some of the costs of deregulation mentioned in the article.

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**Activity 8: Review questions**

1. The aim of microeconomic reform is to move:
  - J. the aggregate demand curve to the right
  - K. the aggregate supply curve to the right
  - L. the long-run aggregate supply curve to the right
  - M. the aggregate demand and aggregate supply curves towards equilibrium.
  
2. Which of the following has not been an outcome of labour market reforms?
  - J. greater flexibility in the labour market
  - K. full employment in the short term
  - L. lower costs faced by firms
  - M. higher levels of labour productivity.
  
3. The reduction of tariffs:
  - J. aims to improve the efficiency of resource use by increasing competition
  - K. increases government revenue
  - L. has been uniform across all industries
  - M. leads to lower productivity because of unemployment.
  
4. Which of the following is a possible disadvantage resulting from microeconomic reform?
  - J. higher levels of cyclical unemployment
  - K. an inequitable distribution of income
  - L. higher rates of inflation
  - M. greater distortion in resource allocation.
  
5. Which of the following is not a benefit from microeconomic reform in the short term?
  - J. improvements in productivity and efficiency of resource use
  - K. better quality of goods and services produced
  - L. higher rates of economic growth
  - M. reductions in unemployment.



Word or phrase	Explanation
microeconomic reform	<p>.....</p> <p>.....</p>
efficiency	<p>.....</p> <p>.....</p>
tariff	<p>.....</p> <p>.....</p>
quota	<p>.....</p> <p>.....</p>
subsidy	<p>.....</p> <p>.....</p>
infrastructure	<p>.....</p> <p>.....</p>
AIRC	<p>.....</p> <p>.....</p>
deregulation	<p>.....</p> <p>.....</p>





## Problems with managing the economy



Read pages 246–250 of the textbook.

So far we have examined both demand management (fiscal and monetary) policies and supply management policies individually. However, in reality the government uses a combination of all types of policies. This is known as the policy mix. The government needs to choose the most appropriate policy mix or combination of measures that maximises Australia's economic wellbeing. The policy mix varies according to the economic problems of the time.

### Activity 1

Complete the table below to show what measures the government could take to stimulate economic activity. The first one has been done for you.

Policy	Increase/ decrease	Price stability	Full employment	Economic growth	External balance
<b>Fiscal policy</b>					
Taxation	decrease	×	✓	✓	×
Government spending					
<b>Monetary policy</b>					
Interest rates					
<b>Microeconomic reform</b>					
Tariffs					
Competition					
Deregulation					
Privatisation					
Labour costs					

### Problems faced by the government in managing the economy

Managing the economy successfully is not easy. Economics is not an exact science, so the government faces a number of problems or limitations in achieving its economic objectives.

#### Conflicting objectives

One government policy can have different impacts on different aspects of the economy. Often there are conflicts between economic objectives. The achievement of one objective might come at the expense of another. For example, microeconomic reforms may be successful in reducing inflationary pressures and improving international competitiveness, but the structural changes involved can lead to higher unemployment. There are also often conflicts between full employment and economic growth on the one hand and external balance and price stability on the other.

These conflicts make it almost impossible for the government to achieve all economic objectives at the same time. As a result they may need to prioritise their policies according to greatest need. For example, from 1997 to 2000 was a period of strong economic activity in Australia. As a result, fiscal and monetary policy were relatively contractionary. In 2000-01 there was a slight downturn in the economy. As a result, fiscal and monetary policy became more expansionary.

**Activity 2**

1. Explain how policies designed to achieve the full employment and economic growth objectives might conflict with the price stability objective.

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2. Explain how policies designed to reduce the current account deficit may conflict with the full employment and economic growth objectives.

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**Limitations of indicators**

The government uses a range of economic indicators to assess the current and likely future state of the economy. Its economic policies are based on forecasts of future economic conditions provided by these indicators. However, interpreting indicators is difficult.

- Many statistics are released as estimates and are 'corrected' as more information becomes available. It is possible that they provide information that is inaccurate or misleading.
- Sometimes the government receives information that is contradictory. For example, retail spending may be low but housing approvals are increasing.

Policies based on these results are likely to be inappropriate. The government may use policies which appear to be correct when in fact they are not. For example, tightening fiscal and monetary policy in the belief that the economy was likely to suffer inflation when in fact the boom period had already passed.

Activity 3

## Mixed signals on growth

Economics has a reputation as the 'dismal science', as economists always look at both the costs and benefits. Never has this been more obvious than when trying to predict the mass of conflicting economic information released last week.

First, oil prices hit record highs before dropping sharply back almost immediately. Then the Australian dollar climbed above US70c, and dropped quickly back. A report showed house prices were falling in many areas, yet ABS statistics showed housing approvals were still strong. The official

figures showed economic growth for the last year was strong overall, yet another survey indicated business confidence about future conditions has deteriorated.

So what do we make of this conflicting information?

Firstly, it is not unusual for there to be mixed signals when markets are at a turning point. An overall assessment of all the data suggests some sort of slowdown is taking place. However, Treasurer Costello stated he was satisfied the economy would continue to run smoothly into next year, due to predicted strong growth in the world economy.

1. Why would it not be unusual for there to be mixed signals when the economy is at a turning point?

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2. What problems would conflicting data present for economic policy makers?

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3. Why should strong growth in the world economy help the Australian economy to grow?

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4. What danger is there for the Treasurer if the world economy does not grow as expected?

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**Time lags**

Time lags refer to the time required to recognise a problem and for a policy to have the desired effect. Changes in policy are subject to the following time lags:

- **Recognition lags**

This is the time taken for the government to decide that an economic problem exists. This occurs because it takes time for economic trends to appear as government officials analyse a range of sometimes conflicting statistics to determine the state of the economy. The collection of statistics also takes time. This means that figures are out of date when they are received.

- **Implementation lags**

Once a problem is recognised, an appropriate policy must be devised and implemented. For example, while monetary policy can be put into effect relatively quickly, fiscal policy is usually implemented once a year through the budget. Also, there is a long political process involved in changing taxes and government spending, so fiscal policy is slow to put into practice. The danger is that policies may be implemented too late, particularly when economic forecasting is imprecise.

- **Effect lags**

Once a policy is implemented, it takes time for it to have an impact on the economy. For example, monetary policy works by changing interest rates which in turn affects aggregate demand through the spending decision of households and firms. However, as many households and firms set spending plans in advance, it takes time (at least six months) for monetary policy to impact on aggregate demand. Fiscal policy, however, can have an impact very quickly. For example, a tax cut leads to an increase in spending almost immediately.

The problem with time lags is that economic conditions can change between recognising the problem and the policy taking effect. Sometimes this has meant that policymakers have actually made a problem worse. For example, raising interest rates to decrease economic activity may cause the economy to move into recession if the policy takes effect after the economy has passed a boom period.

**Activity 4**

1. Explain what is meant by recognition, implementation and effect lags.

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2. Explain why there might be a time lag when the government introduces a cut in income taxes.

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**Policy mix**

The government must take into consideration a number of factors when deciding on the appropriate mix of policy instruments to use.

- **Selecting the right mix**

Some policies are more suitable for achieving some objectives than others. For example, inflation caused by rising production costs is more effectively dealt with using microeconomic reform rather than fiscal or monetary policy. External balance problems could be addressed using fiscal policy or microeconomic reform. Unemployment caused by low levels of aggregate demand could be improved using fiscal policy, monetary policy or some combination of both. However, these measures are generally ineffective in dealing with structural unemployment. Also, if using fiscal and monetary policy, the government must decide whether it should increase government spending, decrease taxation, lower interest rates or some combination of all of these.

- **Size of the action**

Once a particular mix of policies has been decided, the government must decide on the magnitude of that action. For example, how much should government spending be increased, and by how much should taxation rates be cut? If interest rates are to decrease, by how much and for how long? If the government makes incorrect decisions, economic problems could significantly worsen. For example, if policies adopted to combat inflation are too severe, the economy may move into recession.

- **Erratic factors**

Even when an effective policy mix has been decided upon, unexpected and disruptive changes can occur. For example, terrorist attacks may seriously affect tourism and cause balance of payments problems.

**Activity 5**

Explain the possible policy measures the government could take to combat demand-pull inflation. What decisions would the government have to make in relation to these measures?

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**Institutional and political factors**

- **Political factors**

Political factors will have some influence on the government's ability to effectively manage the economy. The desire of government to stay in power may mean that policies are adopted to please voters rather than tackling difficult issues. For example, when economic restraint is required, the government may prefer not to use unpopular policy measures such as increasing tax rates or raising interest rates. The government may be tempted to please voters in an election year by increasing government spending, say, even though this may be against the overall interests of the economy.

- **Pressure groups**

The actions of pressure groups may also add to the government's difficulty in effective economic management. Most economic policies have an impact on certain groups in society. Sometimes pressure groups have enough power to force governments to change or adopt less intense policies to avoid confrontation. For example, a reduction in tariffs was likely to have a significant impact on the motor vehicle industry. As a result, car producers placed a lot of pressure on governments to review their decision (Mitsubishi threatened to close factories in Australia). In response, the government changed its timetable for tariff reductions.

- **Institutional constraints**

There are some institutional constraints on government's ability to manage the economy as well. For example, the Commonwealth government does not have the power to change prices and incomes. Also, the government may have to compromise on its policy in order to get laws passed by parliament. For example, when the government wanted to introduce a GST in 2000, the Democrats refused to pass the relevant legislation unless basic food was excluded from the GST and compensation for low income earners was boosted.

**Activity 6**

Give a current example of a pressure group that is trying to influence the government's decision making on the economy.

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**External influences**

Overseas events can have a significant impact on Australia. Changes in the world level of economic activity will affect our international trade and foreign investment. For example, a worldwide recession will result in reduced demand for our exports and less foreign investment into Australia. Inflation overseas makes our imports more expensive and may cause cost-push inflation in Australia. The government obviously has little control over these matters, but must take them into account when formulating policy. For example, the Asian financial crisis in 1997 reduced Australia's export income and led to a decline in the exchange rate. In response, monetary policy was eased to prevent the economy from slowing.

The government may also be influenced by trends in world economic policy. The reduction of trade barriers occurred at a time when there was a global movement towards free trade, for example. Microeconomic reforms introduced into Australia were similar to those implemented by other countries.

Activity 7

## RBA statement: World downturn to affect growth

November 2001

International conditions are at their weakest for many years. The United States is undergoing a recession. This would be significant for the world economy at any time. However, the fact it is occurring while other regions are also experiencing weakness is all the more cause for concern. Japan remains unable to revive chronically weak economic activity, many countries in east Asia are suffering the effects of the slump in the technology sector, and growth in Europe has weakened considerably.

The weakening of international economic activity has exerted downward pressure on prices for internationally traded goods and

services. Many commodity prices have fallen, adversely affecting Australia's export income. But there has also been downward pressure on prices for many manufactured goods. Therefore, as an importer of high-tech manufactured goods, Australia's terms of trade, and hence our national income, have improved.

The outlook for the global economy is poor and Australia cannot hope to be unaffected. Were it not for the international downturn, prospects for the Australian economy would have been very strong. As inflation is under control it is likely that Australia can fare better than most other economies.

1. What effect is a downturn in international economic activity likely to have on the Australian economy?

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2. How do external influences affect the formulation and implementation of economic policy in Australia?

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Activity 8

**A car-driving analogy**

To illustrate the difficulties faced by a government in designing economic policy, an analogy has sometimes been drawn between managing the economy and driving a car. However, this car has a number of handicaps. The windscreen and side windows are blacked out so you only have the rear-view mirror to guide you. The accelerator, brake and steering wheel do not function instantaneously but take effect only after some time.

Also, you are not alone in the car, but have to deal with a large number of 'back-seat drivers'. These people all have different ideas on how the car should get to its destination. Some of them don't even want to go to the same destination but would prefer to go somewhere else. Even some of those who do want to go to your destination would prefer to take a different route.

Yet another group consider this particular car to be the wrong make to get to their destination. They would like to see the car stopped, pulled apart and the pieces used to build a different machine. Moreover, there is disagreement within this group about what sort of car would be appropriate to build.

What problems of economic management are suggested by the car-driving analogy?

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**The current economic situation and government policy**

In this section you will need to investigate the current economic situation and current government policy and be ready to discuss your findings in class. There are a variety of sources of information. Some suggestions include:

- newspapers (such as *The Advertiser*, *The Australian*, *The Financial Review*)
- magazines such as *The Bulletin*, *Business Review Weekly*.
- if you have access to the Internet, there are several relevant web sites including:
  - [www.abs.gov.au](http://www.abs.gov.au) for the latest statistics
  - [www.rba.gov.au](http://www.rba.gov.au) for information on monetary policy. Their regular statements on monetary policy provide an overview of the economy
  - [www.treasury.gov.au](http://www.treasury.gov.au) provides economic data and forecasts
  - [www.budget.gov.au](http://www.budget.gov.au) for information on the federal budget.

You will need to find out the latest figures and trends, as well as the reasons for any changes. Present your information under the relevant headings on the next page:



**The current economic situation**

Inflation

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Unemployment

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Economic growth

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External balance

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**The current economic policy**

Fiscal policy

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Monetary policy

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Microeconomic reform

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**Activity 9: Review questions**

1. Which of the following tend to be in conflict?
  - J. full employment and lower interest rates
  - K. price stability and external balance
  - L. employment growth and stable prices
  - M. economic growth and full employment.

2. Which of the following policies are likely to be incompatible?
  - J. lower interest rates and a budget surplus
  - K. tight monetary policy and higher taxes
  - L. a budget surplus and higher interest rates
  - M. increased government spending and lower taxes.

3. In a democracy, a limitation on the government’s economic policy making tends to be:
  - J. the size of the public sector
  - K. regular elections
  - L. the amount of taxation revenue available
  - M. the level of government spending.

4. Growth in the world economy may have a negative effect on the Australian economy because:
  - J. export earnings are likely to decrease
  - K. there is likely to be an increase in unemployment
  - L. the current account deficit is likely to decrease
  - M. growth in imports is likely to increase external balance problems.

5. Write an essay plan for the following question:

Evaluate the success of the government in achieving its economic objectives this year, despite the problems of economic management.

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