ECON1102 Macroeconomics 1 ECON1102 Notes Chapter 5 - 8

Chapter 5: Government Sector and Fiscal Policy

Instruments of fiscal policy

- Government expenditure: current goods and services, investment and infrastructure
- Taxes (direct, indirect) income taxes, consumption taxes (GST)
- Transfer payments unemployment benefits, pensions

An increase in government spending has a larger effect on GDP than an exogenous tax cut

- The gov spending multiplier is larger than tax/transfer multiplier
- Taxes and transfer payments affect the level of disposable income (Y-T) received by the private sector
- Exogenous changes in taxes and transfers only have an indirect effect on PAW
- If c is small it means the marginal propensity to consume is small

5.1 Government Sector in Australia

- Macroeconomic activities of the government sector can be classified into three broad categories: spending on final goods and services; raising revenue by levying taxes and making transfer payments
- Government spending is one component of aggregate expenditure in an economy an be decomposed into consumption spending and into capital spending
- Total government spending comprises about 20-25% of GDP
- Main component of government spending is current concernation, with investment spending by various levels of government and one of the concernation businesses amounting to about 5% of GDP
- Transfer payments to individu Is and households include unemployment benefits, old age pensions and other trues of welfare payments

5.2 – Covernment in the income-expenditure model

- Government decisions about G and T can affect the level of output in the economy
- Assume a closed economy (X=M=0)
- In the three-sector economy planned aggregate expenditure is:
 - \circ PAE = C + I^P + G
 - o Where G represents government purchases of goods and services
- In contrast to G, taxes T only affect PAE indirectly, thorough their effect on aggregate consumption expenditure

○ $C = C_0 + c(Y-T) \square (Y-T)$ is disposable income

5.2.1 – tax function

- Many forms of taxation revenue will be positively related to the level of GDP
- We assume that tax revenues are comprised of an autonomous or exogenous component T_0 which is independent of national income, and of an induced or endogenous component which depends on the level of Y and t= marginal tax rate 0 < t < 1
 - $\circ \quad T=T_0+tY$
- We can think of t as the marginal tax rate in an economy

$$\circ \quad \frac{\Delta T}{\Delta} = t$$

- over time a persistently lower level of private investment would result in a lower private capital stock in an economy and this could lead to a lower level of real economic growth
- intergenerational equity 0
 - borrowing because of deficit budgets can't be sustained forever and eventually surpluses would be required to reduce debt
 - intergenerational equity means we should not enjoy the benefits of budget deficits now and pass on the costs of those deficits to future generations
 - as noted above, higher levels of public debt that are not matched by higher levels of productive public infrastructure tend to be inequitable from an intergenerational perspective
- sustainability of public debt .
 - generally agreed that public debt should be sustainable 0
 - we sue the GDP ratio 0

$$d = \frac{D}{Y}$$

- growth in D relative to the growth in Y will cause d to rise and fall 0
- we can derive the following equation to describe the behaviour of the debt to GDP 0 ratio

$$\Delta d_t = rac{(r-g)d_{t-1}}{1+g} - pbb_t$$

- r = real interest rate on public debt
- g = growth rate of real GDP
- PBB = primary budget balance [T_t (with line) G_t G_t etors act to increase debt to GDP ratio
- Two factors act to increase debt to GDP ratio 0
 - Primary budget deficits, O
 - nal GDP, i.e. r>g If real interest rate growth rat eed h
- 5.4 Four Sector Month
 - ector model planed e expenditure (PAE) is given by: 0.1 gi $PAE = C + I^{P} + G + X$
 - The equations describing our economy model are given below $C = C_0 + c(Y - T)$

 $I^p = I_0$ $G = G_0$ $X = X_0$ M = mY

 $T = T_0 + tY$

These can be substituted into the PAE equations

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