

FISCAL POLICY AND INTEREST RATES IN AUSTRALIA

Tax cuts are unlikely to increase interest rates, explains **Stephen Kirchner**

Commentary on recent federal budgets has often focused on the implications of fiscal policy for economic activity, inflation and interest rates. Yet there is little evidence that fiscal policy settings are important to the overall level of interest rates. The contribution of budget surpluses to national saving is subject to offsetting behaviour by the private sector. Australia is a price-taker in global capital markets, so the international influences on Australian interest rates are large relative to domestic influences. Cyclical influences on interest rates are also likely to be large relative to changes in national saving. While changes in the federal budget balance may stimulate aggregate demand, budget measures may also have important implications for the supply-side of the economy. These supply-side implications are a more appropriate focus for fiscal policy than the implications of the budget for aggregate demand, inflation and interest rates.

The federal budget and interest rates

The federal government has maintained an underlying cash surplus since 1996–97, with the exception of a small budget deficit in 2001–02. At the same time, the government has been able to increase spending, implement a series of tax cuts, while running down federal government debt to the point where the Commonwealth is now accumulating a positive net asset position via the Future Fund.¹ The strength of the government's finances reflects the strength of the economy, which

has seen federal revenue collections consistently exceed Treasury forecasts.

It has long been accepted, at least among policymakers and the academic community, that fiscal policy is best focused on microeconomic objectives, with demand management best left to monetary policy. As Alan Reynolds has argued:

The Mundellian or 'supply side' revolution of 1971–86 mainly consisted of assigning price stability to monetary policy while putting much greater emphasis on the microeconomic details of fiscal incentives (marginal tax rates and regulations) rather than the macroeconomic morass of fiscal outcomes (budget deficits and surpluses). The subsequent fiscalist counterrevolution mainly consisted of a renewed fascination with federal borrowing and a revival of theories previously associated with conservative Keynesians of the Eisenhower–Nixon years. The key predictions of this theory were that budget surpluses would increase national savings, reduce real interest rates, and eliminate the current account deficit. All of those predictions proved false.²

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In recent budgets, the federal government has sought to keep the change in the budget balance broadly steady as a share of nominal GDP (the fiscal impulse), in the face of what would otherwise have been a sharp fiscal contraction brought about by higher than expected revenue collections. This is consistent with the view that fiscal policy should be kept broadly neutral in its implications for the overall level of demand in the economy. Since 2001–02, the underlying federal budget surplus has ranged from 1% to 1.6% of GDP, with the change in the budget balance from one financial year to the next generally not exceeding 1% of GDP. It is for this reason that RBA Governors Macfarlane and Stevens have both indicated that fiscal policy has not been a major consideration for monetary policy in recent years. Macfarlane has also questioned the need to run large surpluses, telling the *Australian Financial Review* that ‘I think if you have an economy that is growing at 3%, as we have, there’s no reason why you would need bigger and bigger surpluses, in other words, why you would need to restrain it with some sort of fiscal restraint. What we have got is a tax system which is unintentionally much more income-elastic than anyone designed it to be or even thought it was, and so that even with the economy going at trend growth, we are pulling in a huge amount of taxes and pushing ourselves into surplus.’³

Among financial market economists and economic commentators, there has nonetheless been a widely held view that the government should somehow assist monetary policy in demand

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management, by favouring the accumulation of budget surpluses over tax cuts or new spending, to avoid putting upward pressure on demand, inflation and interest rates. Tax cuts, in particular, have been singled out as likely to put pressure on inflation and interest rates. For example, on 8 December 2006 under the headline ‘Stop Giving Us Money’, *The Weekend Australian’s* George Megalogenis wrote

‘forget more tax cuts, unless you want interest rates to keep rising’. A sample of budget-related headlines in recent years shows the idea that tax cuts lead to higher interest rates is a constant theme in commentary on federal budgets: ‘Tax cuts to force a rate rise’, in *The Australian* on 24 April 2006; ‘Tax cuts lead to rate hike: analyst’, *The Age*, 9 May 2005; ‘Rate rise alert on pre-poll tax cuts’, *The Age*, 19 January 2004. This commentary has come to condition public attitudes to tax cuts. Newspoll found that whereas 66% of respondents favoured tax cuts, this fell to 36% when the possibility of increases in interest rates as a result of the tax cuts was also mentioned.⁴

Federal Treasurer Peter Costello has made this interest rate argument in resisting pressure for tax cuts.⁵ It also appeared to receive official endorsement in a private speech to Treasury officers by Treasury Secretary Ken Henry, who noted that in a fully-employed economy, a fiscal expansion necessarily comes at the expense of the private sector and implies a misallocation of resources away from more productive uses.⁶ Indeed, this may also occur in the context of an economy operating below potential, since government will often make claims on resources that would have been employed by the private sector anyway. Henry said that ‘expansionary fiscal policy tends to “crowd out” private activity: it puts upward pressure on prices which, all things being equal, puts upward pressure on interest rates.’ Henry did not distinguish between an expansionary fiscal policy brought about by increased spending or reductions in taxes, but did note ‘that there is no policy intervention available to government, in these circumstances, that can generate higher national income without first expanding the nation’s supply capacity.’

There are two channels by which fiscal policy might affect interest rates. The first is the effect of fiscal policy on the government contribution to overall national saving. The second is the effect of changes in the budget balance on aggregate demand relative to aggregate supply. The first channel will mainly affect long-term interest rates, while the second channel will mainly affect short-term interest rates. However, since short- and long-term interest rates are typically highly correlated and subject to similar influences, this distinction is not an essential one.

National saving and Ricardian equivalence

Since the federal government has been running budget surpluses and is now accumulating a negative net debt position, the federal government makes no call on domestic capital markets. In this context, the issue is not the extent of 'crowding-out', but the magnitude of 'crowding-in', since the Commonwealth is making a positive contribution to national saving. Although tax cuts and smaller budget surpluses would reduce the amount of government saving, the implications for private and overall national saving are not so straightforward. The theory of Ricardian equivalence, which argues for the substitutability of government debt and future taxes, implies that increased government saving does not increase national saving because of offsetting dissaving by the private sector. There is considerable support for at least some degree of Ricardian equivalence in the literature on the relationship between fiscal policy and national saving. Both international and Australian studies suggest that a 1% increase in public saving typically sees a one-third to one-half percent reduction in private saving.⁷ This private saving offset argues against the use of fiscal policy for demand management purposes. It also helps explain why researchers have struggled to find an empirical relationship between fiscal policy and interest rates, despite the widespread belief in such a relationship among commentators. Robert Barro notes that 'the empirical results on interest rates support the Ricardian view. Given these findings, it is remarkable that most macroeconomists remain confident that budget deficits raise interest rates.'⁸ Similarly, Douglas Elmendorf and Greg Mankiw note that 'this literature has typically supported the Ricardian view that budget deficits have no effect on interest rates.'⁹

Implications of open capital markets

The international and cyclical influences on Australian interest rates can in any event be expected to overwhelm any effect from changes in government and national saving. As a small open economy, Australia is a price-taker in global capital markets and so Australian interest rates tend to be correlated with movements in global financial markets at the expense of domestic influences.

With an open capital account, the domestic saving-investment balance does not determine the level of domestic interest rates, since Australians can call on the saving of foreigners. While Australian and New Zealand interest rates are high by international standards, Australia and New Zealand also have relatively strong fiscal positions relative to comparable countries, which argues against fiscal policy being important in the determination of interest rates. An article by Blair Comley and others examined the effects of changes in the Australian budget balance and net public debt on the spread between Australian real ten year bond yields and their US counterparts. They estimate that a one percentage point increase in the headline budget balance as a share of GDP is associated with a 20 basis point decline in the spread in the short-run, while a one percent increase in public debt as a share of GDP sees a 15 basis point increase in the

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spread in the long-run. However, as the authors themselves note, these estimates are implausibly large for a small, open economy and are likely influenced by the inclusion of data from an era of much higher public debt levels than found in Australia today. They conclude that 'we would be surprised if further debt reduction had as large an incremental effect in this era of low debt.'¹⁰

The implausibility of these results is also suggested by the lack of evidence for a relationship between fiscal policy and interest rates in the US, given that the US is a country large enough to be an effective price-maker in global capital markets. Researchers have struggled to find a statistically robust and economically significant relationship between US fiscal policy and interest rates. In their review of the literature, James Barth and his co-authors note that 'there is not now a clear consensus on whether there is a statistically and economically significant relationship between government deficits and interest rates. Since the

available evidence on the effects of deficits is mixed, one cannot say with complete confidence that budget deficits raise interest rates and reduce saving and capital formation. But, equally important, one cannot say that they do not have these effects.¹¹ Eric Engen and Glenn Hubbard have argued that because 'the likely interest rate effects of changes in federal government debt consistent with US historical experience may be in the range of single-digit basis points, this poses a particular burden on empirical analysis to estimate these effects with less-than-perfect data and econometric techniques.'¹² While Engen and Hubbard are sympathetic to finding an effect from fiscal policy on US interest rates, their own evidence suggests that this effect is economically trivial, as well as not being statistically robust.

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Cyclical influences

It is worth recalling that the much maligned 'high interest rates' of the late 1980s were associated with some of the largest budget surpluses as a share of GDP since the early 1970s. The federal government ran an underlying cash surplus of 1.7% of GDP between 1988–89 and 1989–90, larger than any budget surplus delivered by Peter Costello in his 11 years as Treasurer. The change in the federal budget balance was consistently contractionary between 1983–84 and 1989–90, including four years of budget surpluses between 1987–88 and 1990–91. If a budget surplus is effective in lowering interest rates, it is far from apparent from this experience. Changes in the level of interest rates are positively, not negatively correlated with changes in the budget balance, because both are positively correlated with the business cycle. These business cycle influences are very large relative to any plausible contribution of increased government saving to national saving and domestic interest rates.

Supply-side influences

It is often argued that a positive fiscal impulse from the budget will increase aggregate demand pressures relative to aggregate supply, if only at the margin, adding to upward pressure on inflation and short-term interest rates. This ignores the supply-side of the equation. The unemployment rate has recently fallen to its lowest level since the end of 1974 and this has been one of the Reserve Bank's concerns in relation to the inflation outlook. The multi-decade lows in the unemployment rate have also been associated with record highs in the labour force participation rate. Increased labour force participation is important in preventing the labour market becoming a potential source of inflationary pressure. Changes in both government spending and taxes can be useful in inducing increased labour supply and this may be a more significant influence on interest rates than the effect of changes in the budget balance on demand and national saving.

This proposition seems to be more readily accepted in relation to increased government spending on things such as childcare, but less readily accepted in relation to tax cuts. Small changes in incentives can induce large behavioural responses, as evidenced by the government's cash 'baby bonus', which has been associated with the highest number of births in 35 years and the second highest on record.¹³ Yet the idea that small changes in incentives can bring about large behavioural responses seems to have very little acceptance when discussion turns to tax cuts, perhaps because the mechanisms involved are less obvious than in the case of more targeted government spending programs.

Treasury Secretary Ken Henry noted that Treasury modelling of the 2007 budget tax cuts showed that they 'might increase labour supply by about 0.1 hours per week. If this additional supply is fully employed, the increase in labour utilisation will lift the employment ratio by about a third of a percentage point.'¹⁴ The benefits of tax cuts extend well beyond their positive implications for labour supply, to issues relating to the deadweight losses, compliance and collections costs that flow from the operation of the tax system, all of which imply that tax cuts have the capacity to increase supply more broadly, not just in the labour market.¹⁵

The appropriate focus for fiscal policy is precisely these microeconomic and supply-side issues, not demand management.

Conclusion

Fiscal policy is unlikely to have been important in the determination of Australian interest rates in recent years. As a small, open economy, with an open capital account, Australian interest rates are largely determined by international and cyclical influences that can be expected to overwhelm any contribution from changes in the federal budget balance, government and national saving. There is little evidence, either in Australia or internationally, for an economically or statistically significant effect from fiscal policy on interest rates. This is most notably the case in the US, which is large enough to influence pricing in global capital markets. The private saving offset to changes in public saving argues against the use of fiscal policy for demand management purposes. The analysis of the implications of fiscal policy for output, inflation and interest rates needs to go beyond simple calculations of the fiscal impulse and its impact on demand, to a consideration of the implications of budget measures for the supply-side of the economy, where fiscal policy can potentially make a more important contribution to enhancing national welfare.

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Endnotes

- 1 See Stephen Kirchner, 'Future Fund or Future Eater', *Policy* 22:3 (Spring 2006), pp 28–31.
- 2 Alan Reynolds, 'The Fiscal-Monetary Mix', *Cato Journal* 21:2 (Fall 2001), p 263.
- 3 Cited in 'RBA governor questions rising surplus', *AAP*, 5 September 2006.
- 4 Newspoll survey carried out 27–29 April 2007, reported in Dennis Shanahan, 'Two-thirds want tax cuts: Newspoll', *The Australian*, 1 May 2007. Full details available at www.newspoll.com.au.
- 5 See, for example, 'No tax cuts until we return to frugality', *The Australian*, 18 June 2006. Costello told the NSW Liberal Party's State Policy Conference that 'the States are borrowing—drawing down on savings [sic] rather than adding to them—and in this respect adding to pressure on monetary policy', Menzies Research Lecture, State Policy Conference, Hilton Hotel, Sydney, 1 June 2007.
- 6 Ken Henry, Secretary's speech to Staff, 14 March 2007.
- 7 See Blair Comley, Stephen Anthony and Ben Ferguson, 'The Effectiveness of Fiscal Policy in Australia: Selected Issues', *Economic Roundup* (Winter 2002).
- 8 Robert Barro, 'The Neoclassical Approach to Fiscal Policy', in *Modern Business Cycle Theory* ed. Robert Barro (Cambridge: Harvard University Press, 1989).
- 9 Douglas Elmendorf and Greg Mankiw, 'Government Debt', in *Handbook of Macroeconomics* eds. John Taylor and Michael Woodford (Amsterdam: Elsevier Science, 1999).
- 10 See Blair Comley, Stephen Anthony and Ben Ferguson, 'The Effectiveness of Fiscal Policy in Australia: Selected Issues', *Economic Roundup* (Winter 2002), p 66.
- 11 James Barth, George Iden, Frank Russek and Mark Wohar, 'The Effects of Federal Budget Deficits on Interest Rates and the Composition of Domestic Output', in *The Great Fiscal Experiment* ed. Rudolph Penner (Washington, DC: The Urban Institute Press, 1991), p 71.
- 12 Eric Engen and Glenn Hubbard, *Federal Government Debt and Interest Rates*, AEI Working Paper No 105 (Washington, DC: American Enterprise Institute, 2 June 2004), p 4.
- 13 Michael McKinnon and Clara Pirani, 'Baby bonus boosts birthrate by 10,000', *The Australian*, 16 September 2006.
- 14 Ken Henry, address to Australian Business Economists, 15 May 2007.
- 15 These issues have been addressed extensively in the series of papers, 'Perspectives on Tax Reform' by The Centre for Independent Studies (Sydney: The Centre for Independent Studies, 2004–2007).