Shelter NSW 'Housing economics for non-economists' lecture series: Lecture 1

Professor Frank Stilwell on the political economy of housing

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LOOKING AT BUDGETS (FROM A POLITICAL ECONOMIC PERSPECTIVE)

When a government (federal or state) announces its annual budget, it is pertinent to ask the following five questions:

1. How appropriate is the budget for the macroeconomic conditions?

The primacy of this question reflects the standard Keynesian view that budgets should contribute to stabilizing the economy. Budgetary policy can play a role in smoothing out the cyclical pattern of booms and slumps to which capitalist economies have always been prone. On this reasoning, when economic growth has slowed – as has recently been the case in Australia – one would expect the government to budget for a deficit (an excess of spending over revenue) in order to stimulate the economy and create more jobs. As Keynes argued, planning to have a budget deficit makes good economic sense in these circumstances. Whether it makes good environmental sense is a question to come back to (see point 4 below); but good budgetary policy can certainly help to avoid deepening economic recession.

As Keynesian economists have emphasised, it is also necessary to keep an eye on the rate of inflation. If the government judges that the inflation rate is likely to rise and that this has been caused by a high overall level of demand for goods and services, it may choose to prioritise this concern in its budget. In that case, the government should budget for a surplus (an excess of revenue over spending). However, this is a hazardous course of action if the problem of inflation arises because of some reason other than high overall demand – a rise in the price of imported oil, for example. In that case, a budget surplus is less likely to resolve the problem of inflation. It could increase unemployment. When there is both inflation and unemployment – the deeply troublesome combination generally called 'stagflation' – the appropriate budgetary stance becomes unclear. In general, stagflation requires a Keynesian approach to budgetary policy to be accompanied by other policies, such as those dealing with the distribution of income between wages and profits.

The main *political* problem with deficit budgeting in the current era is that governments running budget deficits are regarded by many (non-Keynesian) economic commentators as inefficient economic managers. That criticism shows a misunderstanding of the difference between household budgets and government budgets. However, the misunderstanding is widespread. So governments, fearful of being criticised in this way, have tended to avoid using budgets for anti-cyclical policy. That throws the major burden of macroeconomic management onto monetary policy, particularly the periodic adjustment of official interest rates by the Reserve Bank. This is unfortunate because, as Keynes suggested, monetary policy is the 'heavy blunt instrument' in the armoury of economic policy, causing much social damage when rising interest rates impact adversely on house purchases and business investors. Monetary policy is also insensitive to different regional economic conditions since, unlike budgetary policy, it cannot be targeted differently at different parts of the economy according to their local needs.

2. What impact does the budget have on the distribution of incomes?

Budgeted changes to government spending and taxes always have distributional consequences. So, ‘who gets what?’ is an obvious question to ask about the budget. Indeed, it is the characteristic newspaper headline on the day after any government budget is announced. However, it is sometimes difficult to discern the net effect of multiple, concurrent changes in the rate of taxation and patterns of government spending. Some aspects are reasonably clear, though. For example, making a particular payment such as the family allowance or a ‘household stimulus package’ available only to households below a specified income level is a means of trying to cut-out ‘upper-class welfare’. On the other hand, if a government reduces rates of income tax, this generally benefits higher income groups, even when the cuts are to the lower marginal tax rates. This is because raising the tax-free threshold or cutting the tax rates on lower incomes also reduces the taxes paid by people on higher marginal tax rates. Indeed, cuts in income tax rates are usually worth more, in absolute dollar terms, for higher income earners. So this causes more inequality in after-tax incomes.

Other issues to look out for in budgets relate to new forms of taxation or government expenditure. Advocates of a more egalitarian society have commonly put the case for new taxes, such as inheritance tax or an annual wealth tax. Others contend that a more universal land tax, without the existing exemptions for owner-occupied households, could be the basis of creating a fairer society because it appropriates part of the social surplus that currently accrues to land owners irrespective of any productive contribution to the economy. On the expenditure side of the budget, it important to keep an eye on any new programs that are introduced and to ask if the social groups most likely to benefit are generally rich or poor.

Distributional changes are important not only because issues of fairness are involved; they can also affect the overall level of economic activity in the longer term. Advocates of progressive redistribution argue that a more equitable society is likely to be more productive because it is less conflict-riven. Advocates of more *in*equality take a quite different view, based on the alleged disincentive effects arising from policies to redistribute incomes from rich to poor. However, there is no systematic evidence that income tax-cuts, for example, have a positive impact on work and productivity. As neoclassical economic theorists themselves acknowledge, the impact of a tax change depends upon the relative size of two effects. The ‘substitution effect’ involves people substituting work for leisure as a result of a tax cut because each hour of work now has a higher after-tax reward. Simultaneously, the ‘income effect’ leads people to work less, because they don’t need to work so many hours to generate the same after-tax income as before. The net outcome of these two opposite effects can go either way. In practice, policies claiming to increase incentives in the economy are usually more about re-distribution from poor to rich. So, ultimately, this is a class issue.

3. What social priorities does the budget embody?

A budget also reflects the government’s social agenda. Indeed, this is its most obvious feature, because budgets invariably increase some forms of expenditure relative to others. What are the public spending priorities? The army or universities? Expenditure on childcare or pensions? Public housing or business subsidies? The political priorities are usually not difficult to discern.

More generally, it is important to consider how much the government wants to divert spending from individuals to society as a whole. For example, is it giving income tax cuts that leave individuals with more after-tax personal spending power OR it is raising taxes to the level necessary for financing more public infrastructure and better social services? As the political economist J.K. Galbraith consistently argued, unless the government uses the budget to fund a good quality public sector, the problem of ‘social imbalance’ between ‘private wealth and public squalor’ is perpetuated. So, the total level of social spending (and the total level of taxes used to fund that spending) signifies the extent to which the government is addressing Galbraith's concern.

A budget is essentially a political document showing the government's social priorities – and the sectional interest groups that the government is courting. The social priorities may reflect electoral promises but do not necessarily do so. The actual policies implemented are often adapted in the light of lobbying from interests groups during the budget formulation process.

4. Will the budget contribute to a better quality physical environment?

Budgets can be used for the pursuit of environmental goals if governments are inclined to do so. Any environmental policy usually has budgetary implications. The federal government's proposed Carbon Pollution Reductions Scheme, for example, would generate new forms of income (through the sale of emissions permits) and new forms of expenditure too. The budgetary implications of the introduction of a carbon tax would be even more striking. A carbon tax would see goods taxed according to the amount of non-renewable energy resources that go into their manufacture. That would discourage production and consumption of those goods. It would be preferable, from an ecological perspective, to use this tax as a replacement for 'non-discriminatory' taxes, such as the current goods and services tax (GST), which do not encourage changes in production and consumption towards more sustainable patterns. Adjustments to petrol excise can have a similar effect. Cutting the fuel excise, on the other hand, would encourage more use of this non-renewable resource than would otherwise be the case. Clearly, the form of taxation on which a budget is based needs to be evaluated in terms of sustainability.

The macroeconomic issue is also important in this context. A budgetary deficit may be used, as noted earlier, to expand the economy and reduce unemployment. While that is admirable from a conventional economic perspective, it can mean greater pressure on scarce environmental resources. So, from a green perspective, it is important that any such economic stimulus be linked to policies that promote the restructuring of the economy on more ecologically sustainable principles.

Government expenditures have different environmental impacts. For example, a budget can steer investment directly into more ecologically sustainable industries by providing subsidies to industries developing solar power or other renewable energy technologies. Government expenditures could also go directly to funding and promoting more 'green jobs'. Whether a government implements such a policy is political choice, one that has a major bearing on the future prospects for reconciling economic and ecological concerns.

5. What will be the international economic outcomes?

Although a budget is primarily about managing the national economy (or a state economy within a federal system such as Australia), it also has the capacity to affect international trade and particularly capital flows. This is important in the Australian context, because the economic policies pursued by both the ALP and Liberal-National governments over the past four decades have reduced barriers to international trade and capital movements. So, if the budget boosts domestic consumers' after-tax incomes (as the federal government's household stimulus package did in the short-term), that tends to result in more spending on imported goods. This then increases the nation's current account deficit, unless the growth of imports is matched, coincidentally, by increased exports.

Australia's current account deficit continues to be a substantial concern. It requires capital inflow to balance it, which creates growing dependence on foreign investment. A national government concerned about this situation could introduce policies deigned to encourage the growth of export industries and import-competing industries. It could allocate funds for this purpose in its budget. However, such ‘interventionist’ industry policies are largely unacceptable to governments influenced by the neo-liberal ideas that are inimical to economic planning.

Other specific features of budgets also have international implications. For example, the strength of the national government’s commitment to overseas development aid is indicated by the amount it allocates in the budget for this purpose. It is also pertinent to note, however, that how aid is spent has a major bearing on whether it actually helps the development of poorer nations in practice.

Conclusion

The five themes identified above indicate some important questions to ask about budgets. They are not exhaustive, and other aspects of budgets can also be of social, economic and political significance. However, the five main themes are generally a good starting point for critically analysing a budget from a political economic perspective.

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