Unit - 4 Fiscal Policy

Page :
Date :

1 Introduction.

→ Budgetary policy could be broadly classified into public revenue (1) including taxation, public expenditure (2), public debt (3) and finally deficit financing (4).

→ Fiscal policy is the deliberate policy of the government under which it uses the instruments of :-

- Taxation
- Public expenditure
- Public Borrowings

→ Fiscal policy is in the nature of demand side policy.

Imp
→ An economy which is producing at full employment level does not require government action in the form of fiscal policy.

2 OBJECTIVES OF FISCAL POLICY

→ Achievements & maintenance of full employment

→ Maintenance of price stability

→ Acceleration of the rate of economic development

→ Equitable distribution of income & wealth

* $GDP = C + I + G + NX$

(3) TYPES OF FISCAL POLICY

Expansionary fiscal policy

- It is a policy measure to close a recessionary gap (i.e. deflation)

  economy में demand कम है।

- Cut all types of taxes.
- Increase in Public expenditure
- While resorting to expansionary fiscal policy, the government may run into budget deficits.

Contractionary fiscal policy

- It refers to the deliberate policy of government applied to curtail aggregate demand and consequently the level of economic activity in other words, it is a fiscal policy to eliminate Inflationary gap
- Increase in taxes
- Decrease in public expenditure
- Contractionary fiscal policy should ideally lead to smaller budget deficit

INSTRUMENTS OF FISCAL POLICY

Government Expenditure

- Current expenditures to meet day to day running of the government
- Capital expenditure (in form of investment)
- Transfer payments (which do not contribute to GDP)

↑ Expenditure - AD↑ Inflation ↑
↓ Expenditure - AD↓ Inflation ↓

TAXES

- Direct Tax
- Indirect Tax

Tax↑ Disposable Income ↓ AD↓

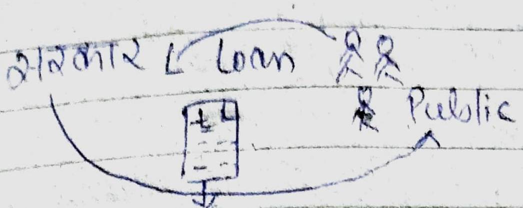
Public Debt

- Internal
- External

$\underbrace{\text{Internal} \quad \text{External}}_{\text{Forms of Public debt}}$

Market Loans

Small Savings



Treasury bills, govt securities, bond

Negotiable (✓)
Tradeable (✓)

It represent public borrowings, which are not negotiable and are not traded
e.g (Natural savings certificate, national development certificate etc.)

Public debt (↑) AD (↓)
Public debt (↓) AD (↑)

★ ~~Budget~~

★ Important points relating to Fiscal policy

1. Budget as Instrument of Fiscal policy

→ Balanced Budget : $\boxed{TR = TE}$ (No effect)
(Leakages = Injections)

→ Surplus Budget : $\boxed{TR > TE}$ → खर्चा कम है। AD (↓)
(Leakages > Injection)

→ Deficit Budget : $\boxed{TR < TE}$ AD ↑
खर्चा ज्यादा है।
(Leakages < Injection)

Page:
Date:

2 Fiscal policy for Long Run Economic Growth

→ Fiscal policy such as those involving infrastructure spending generally have positive supply side effects.

→ Government provision for public goods such as education, healthcare, nutrition etc provide momentum for long run economic growth.

→ Tax and spending policies can be effectively used to correct market failure resulting from externalities

Fiscal policy for Reducing Inequalities of Income

→ Progressive direct tax System

→ Differential Indirect tax system

e.g { luxury goods → 28% Tax
Necessity goods → less tax }

→ Other measures :-
-> Poverty alleviation programmes
-> free or subsidized medical care, education, housing etc.
-> various social security scheme

(4) Limitation of Fiscal Policy

(i) Different lags :-

(a) Recognition lag :- There is difficulty in collecting accurate & timely data

(b) Decision lag :- Delays are likely to occur to make decision on the most appropriate policy

(c) Implementation lag :- Even when appropriate policy measures are decided on, there are possible delays in bringing in legislation & implementing them

(d) Impact lag :- It occurs when the outcomes of a policy are not visible in sometime.

(ii) It is pratically difficult to reduce government spending on various items

(iii) Public works cannot be adjusted easily along with movements of trade cycle
{e.g. highway → {long gestation period}}

(iv) Supply side economists are the of the opinion that certain fiscal measures will cause disincentives

Page :
Date :

{ Profit Tax (↑) Investor / Producer ☹ }

(v) Increase in government borrowing will create perpetual burden of debt on future

(5) CROWDING OUT

→ Increase in government spending during recessions will "crowd out" private spending in economy.

→ In other words when spending by government in an economy replaces private spendings, the latter is said to be crowded out.

→ As a result, the effectiveness of expansionary fiscal policy in stimulating aggregate demand will be diminished to a great extent (may possibly reduce economy's prospects of long term economic growth).

☆ However during deep recessions, crowding out is less likely to happen as private investments are already minimal.

Eg. Recession
↓
Employment ↓
Prices ↓
Demand ↓

Government spending ↑↑↑
Private sector ↓↓↓↓ Crowding