Unit IV - Fiscal Policy

* Introduction

→ Budgetary policy could be broadly classified into Public revenue including taxation, public expenditure, public debt and finally deficit financing.

→ Fiscal Policy is the deliberate policy of the govt. under which it uses the instruments of :-

- Taxation
- Public expenditure
- Public borrowing

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

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

* **Objectives of Fiscal Policy :-**

(a) Achievement and maintenance of full employment

(b) Maintenance of price stability

(c) Acceleration of the rate of economic development

(d) Equitable distribution of Income and wealth

→ $\boxed{GDP = C + I + G + NX}$

Types of Fiscal Policy

- Expansionary fiscal policy
- Contractionary fiscal policy

1.) **Expansionary fiscal policy**

- It is a policy measure to close a recessionary gap (i.e Deflation) →(Demand is low).
- cut all types of taxes
- increase in public expenditure
- while resorting to expansionary fiscal policy, the govt. may run into BUDGET DEFICITS.

2.) **Contractionary fiscal policy**

- It refers to 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 <u>Smaller Budget deficit</u>.

* Instruments of Fiscal Policy

1.) Government Expenditure

(a) Current expenditures to meet day to day running of the govt.

(b) Capital expenditures in form of investment

(c) Transfer payments - which do not contribute to GDP

• ↑ Expenditure - ↑ Aggregate Demand - ↑ Inflation
• ↓ Expenditure - ↓ Aggregate Demand - ↓ Inflation

2.) Taxes

(a) Direct Tax (b) Indirect Tax

• ↑ Taxes - Disposable Income ↓ - Aggregate Demand ↓
• ↓ Taxes - Disposable Income ↑ - Aggregate Demand ↑

3.) Public Debt

(a) Internal (b) External

→ Forms of public debt:-

- Market loans
  ↓
  loan from market (eg. issuing bonds) treasury bill etc.,
  ↓
  negotiable & tradable

- Small savings
  ↓
  It represent public borrowings which are <u>not negotiable</u> & are <u>not traded</u>.
  (eg. National Savings Certificate, National Development Certificate)

Public Debt ↑ - Aggregate Demand ↓
Public Debt ↓ - Aggregate Demand ↑

* **Important points relating to Fiscal Policy**

1.) **Budget as Instrument of Fiscal Policy**

(a) Balanced Budget : Total receipts = Total expenditure [No effect on AD]
→ $\boxed{\text{Leakages} = \text{Injections}}$

(b) Surplus Budget : Total receipts > Total expenditure [Aggregate Demand ↓]
→ $\boxed{\text{Leakages} > \text{Injections}}$

(c) Deficit Budget : Total receipts < Total expenditure [Aggregat Demand ↑]
→ $\boxed{\text{Leakages} < \text{Injections}}$

2.) **Fiscal Policy for Long run Economic Growth**

→ Fiscal policies such as those involving infrastructure spending generally have positive supply side effect.

→ Government provisions for public goods such as Education, Heath care, Nutrition etc., provide momentum for long run economic growth.

→ Tax and Spending policies can be effectively used to correct market failures resulting from externalities.

3.) **Fiscal Policy for reduction in Inequalities of Income and Wealth**

→ progressive direct tax system

→ Differential indirect tax system [different taxes on luxury goods and Necessity goods]

→ Other measures:-
- poverty alleviation programs
- free/subsidised medical care, education
- various social security schemes (eg. old age pensions)

4.) **Limitations of Fiscal Policy**

(i) Different lags

(a) Recognition lags - There is difficulty in collecting accurate and timely data.

(b) Decision lags - Delays are likely to occurr to make decision on the most appropriate policy

(c) Implementation lags - Even when appropriate policy measures are decided on, there are possible delays in bringing in legislation & implemting them.

(d) Impact lags - It occurrs when the outcomes of a policy are not visible in some time.

(ii) It is practically difficult to reduce government spendings on various items.

(iii) Public works cannot be adjusted easily along with movements of trade cycles

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

(v) Increase in government borrowings will create Perpetual Burden of Debt on future

5.) **Crowding Out**

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

→ In other words, when spending by govt. in an economy replaces private spendings, the later 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.