Fiscal Policy

- Fiscal policy refers to the use of government spending and tax policies to influence economic conditions, especially macroeconomic conditions, including aggregate demand for goods and services, employment, inflation, and economic growth.
- Fiscal policy is largely based on ideas from John Maynard Keynes, who argued governments could stabilize the business cycle and regulate economic output.
- During a recession, the government may employ expansionary fiscal policy by lowering tax rates to increase aggregate demand and fuel economic growth.
- In the face of mounting inflation and other expansionary symptoms, a government may pursue contractionary fiscal policy.

Constituents of Fiscal Policy

- Fiscal policy has three components.

1. **Government outlays or expenditure**, which includes predetermined sequences of government purchases of goods, services and transfer/entitlement payments.
2. **Tax structure**: This includes time invariant tax rates on consumption, labour income, capital income production of goods and services.
3. **Government debt**: It comprises of government borrowings from internal as well as external sources.

- **The fiscal policy is designed to achieve certain objectives as follows:-**
- **1. Development by effective Mobilisation of Resources:** The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by Mobilisation of Financial Resources. The central and state governments in India have used fiscal policy to mobilise resources.
- **The financial resources can be mobilised by:**-
- a. **Taxation:** Through effective fiscal policies, the government aims to mobilise resources by way of direct taxes as well as indirect taxes because most important source of resource mobilisation in India is taxation.
- b. **Public Savings:** The resources can be mobilised through public savings by reducing government expenditure and increasing surpluses of public sector enterprises.
- c. **Private Savings:** Through effective fiscal measures such as tax benefits, the government can raise resources from private sector and households. Resources can be mobilised through government borrowings by ways of treasury bills, issuance of government bonds, etc., loans from domestic and foreign parties and by deficit financing.

- **2. Reduction in inequalities of Income and Wealth:** Fiscal policy aims at achieving equity or social justice by reducing income inequalities among different sections of the society.
- The direct taxes such as income tax are charged more on the rich people as compared to lower income groups.
- Indirect taxes are also more in the case of semi-luxury and luxury items which are mostly consumed by the upper middle class and the upper class.
- The government invests a significant proportion of its tax revenue in the implementation of Poverty Alleviation Programmes to improve the conditions of poor people in society.

- **3. Price Stability and Control of Inflation:** One of the main objectives of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by reducing fiscal deficits, introducing tax savings schemes, productive use of financial resources, etc.

- **4. Employment Generation:** The government is making every possible effort to increase employment in the country through effective fiscal measures. Investment in infrastructure has resulted in direct and indirect employment.
- Lower taxes and duties on small-scale industrial units encourage more investment and consequently generate more employment. Various rural employment programmes have been undertaken by the Government of India to solve problems in rural areas.
- Similarly, self employment scheme is taken to provide employment to technically qualified persons in the urban areas.

- **5. Balanced Regional Development:** there are various projects like building up dams on rivers, electricity, schools, roads, industrial projects etc. run by the government to mitigate the regional imbalances in the country. This is done with the help of public expenditure.
- **6. Reducing the Deficit in the Balance of Payment:** some time government gives export incentives to the exporters to boost up the export from the country. In the same way import curbing measures are also adopted to check import. Hence the combine impact of these measures is improvement in the balance of payment of the country.

- **7. Increases National Income:** it’s the strength of the fiscal policy that is brings out the desired results in the economy. When the government want to increase the income of the country, it increases the direct and indirect taxes rates in the country. There are some other measures like: reduction in tax rate so that more people get motivated to deposit actual tax.

  8. Development of Infrastructure: when the government of the concerned country spends money on the projects like railways, schools, dams, electricity, roads etc to increase the welfare of the citizens, it improves the infrastructure of the country. A improved infrastructure is the key to further speed up the economic growth of the country.

  9. Foreign Exchange Earnings: when the central government of the country gives incentives like, exemption in custom duty, concession in excise duty while producing things in the domestic markets, it motivates the foreign investors to increase the investment in the domestic country.

- **Countercyclical fiscal policy during recession**

Here, the Government’s responsibility is to generate demand by fine-tuning taxation and expenditure policies. Reducing taxes and increasing expenditure will help to create demand and producing upswing in the economy.

- **Countercyclical fiscal policy during boom**

In the case of boom, economic activities will be on upswing. Amplifying the boom is disastrous as it may create inflation and debt crisis and the government’s responsibility here is to bring down the pace of economic activities. Increasing taxes and reducing public expenditure will make boom mild. Thus, slowing down demand should be the nature of countercyclical fiscal policy during boom.

Contractionary Fiscal Policy

- When an economy is in a state in which growth is getting out of control and therefore causing inflation and asset price bubbles, a contractionary fiscal policy can be used to rein in this inflation—to bring it to a more sustainable level.
- A contractionary policy will lower government spending and/or increase taxation. This policy will shift aggregate demand to the left (this denotes a decrease).
- A fiscal policy is said to be tight or contractionary when revenue is higher than spending (i.e. the government budget is in surplus) and loose or expansionary when spending is higher than revenue (i.e. the budget is in deficit).
- Contractionary fiscal policy slows growth, which includes job growth. With fewer jobs, and higher taxes, both families and businesses are left with less income available for spending. With this decreased demand, then, the economy’s growth is slowed.

Expansionary Fiscal Policy

- Since, Aggregate Demand = Consumption + Investment + Government Spending + Net Exports, an expansionary policy will shift aggregate demand to the right. This kind of policy involves decreasing taxes and/or increasing government spending.
- An expansionary fiscal policy is typically used during a recession. A decrease in taxation will lead to people having more money and consuming more. This should also create an increase in aggregate demand and could lead to higher economic growth. However, it can also lead to inflation because of the higher demand within the economy.

- Expansionary fiscal policy creates jobs. With more jobs, the overall populace has more funds to spend, leading to higher levels of demand. This creates growth in the economy. Along with tax cuts, growth is especially accelerated. Among the best stimuli for the economy are unemployment benefits, proven empirically via economic studies. Tax cuts are less effective in creating jobs, as the tax rate must already be high for lowering taxes to do so.
- The drawback of expansionary fiscal policy is that it can lead to budget deficits. This is because the government is effectively spending more than it ends up receiving in taxes.

Criticisms of Fiscal Policy

- **1. Time Lag**

Fiscal policy is characterized by a time lag, which is the time between the implementation of policy and the actual effects of that policy being felt in the economy.

- **2. Expansionary Bias**

It has an expansionary bias. No government or politician would implement a contractionary policy, so this means that expenditure will keep rising and taxes would probably not rise too.

- **3. Execution**

Contractionary policy is difficult to implement because no one wants cuts in spending. Education, defense, and health are priorities and most people want to ensure that they are adequately funded. It also cannot be maintained indefinitely. It is considered to be a short-term tool, not a long-term solution.

- 4. Trade Deficit

Expansionary fiscal policy can lead to a higher trade deficit, as higher income leads to more expenditure on imports and a higher negative trade balance.

- 5. Crowding Out

An expansionary policy may lead to crowding out. Crowding out occurs when a big government borrows money. This leads to higher interest rates for the private sector, which ultimately leads to less private investment.