Fiscal Policy

The means by which the government adjust its spending levels along with tax rates to influence and monitor the nation's economy it is known as fiscal policy. Let us learn the Fiscal Policy of India here.

Fiscal Policy of India

There are several component policies or a mix of policies that contribute to the fiscal policy. These include subsidy, taxation, welfare expenditure, etc. Also, there are a certain investment and disinvestment policies and debt and surplus management that contributes to fiscal policies.

Objectives of a Fiscal Policy

- In order to stabilize the pricing level in the economy.
- The main objective is to achieve and maintain the level of full employment in the country.
- Also, to stabilize the growth rate in the economy.
- Also, promote the economic development in a country.
- In order to maintain the level of balance of payment in the economy.

Various Types of Fiscal Policies

Contractionary Fiscal Policy

This involves cutting government spending or raising taxes. Thus, the tax revenue generated is more than government spending. Also, it cuts on the aggregate demand in the economy. So, the economic growth leading to the reduction in inflationary pressures of the economy.

Expansionary Fiscal Policy

This is generally used to give a boost to the economy. Thus, it speeds up the growth rate of the economy. Also, during the recession period when the growth in national income is not enough to maintain the current living of the population.

So, a tax cut and an increase in government spending would boost economic growth and decrease the unemployment rates. Although this is not a sustainable solution. Because this can lead to a budget deficit. Thus, the government should use this with caution.

Neutral Fiscal Policy

This policy implies a balance between government spending and Furthermore, it means that tax revenue is fully used for government spending. Also, the overall budget outcome will have a neutral effect on the level of economic activities.

Types of Fiscal Policy

There are major components to the fiscal policies and they are

Expenditure Policy

Government expenditure includes capital expenditure and revenue expenditure. Also, the government budget is the most important instrument that embodies government expenditure policy. Furthermore, the budget is also for financing the deficit. Thus, it fills the gal between income and government spending.

Taxation Policy

The government generates its revenue by imposing both indirect taxes and direct taxes. Thus, it is important for the government to follow a judicial system for taxation and impose correct tax rates. This is because of two reasons. The higher the tax, the reduction in the purchasing power of the people.

This will lead to a decrease in investment and production. Furthermore, the lower tax will leave more money with people that lead to high spending and thus higher inflation.

Major Instruments of Fiscal policy are

Some of the major instruments of fiscal policy are as follows: A. Budget B. Taxation C. Public Expenditure D. Public Works E. Public Debt.

A. Budget:

The budget of a nation is a useful instrument to assess the

Different budgetary principles have been formulated by the economists, prominently known as:

(1) Annual budget,

(2) cyclical balanced budget and

(3) fully managed budget

Let us briefly explain them:

1. Annual Balanced Budget:

The classical economists propounded the principle of annually balanced budget. They defended it with force till the deep rooted crisis of 1930's.

The reasons for their reacceptance of this principle

(i) They maintained that there should be balance in income and expenditure of the government;

(ii) They felt that automatic system is capable to correct the evils;

(iii) Balanced budget will not lead to depression or boom in the economy;

(iv) It is politically desirable as it checks extravagant spending of the state;

(v) This type of budget assures full employment without inflation;

(vi) The principle is based on the notion that government should increase the taxes to get more money and reduce expenditure to make the budget balanced.

However, this principle is subject to certain objections.

These objection are as under:

(i) Classical version that balanced budget is neutral is not well based. In practice, a balanced budget .

(ii)The assumptions of full employment and automatic adjustment are too untenable in a modern economy.

(iii)Some economists also argue that annually balanced budget involves lesser burden of the taxes.

2. Cyclically Balanced Budget:

The cyclical balanced budget is termed as the 'Swedish budget'. Such a budget implies budgetary surpluses in prosperous period and employing the surplus revenue receipts for the retirement of public debt. During the period of

recession, deficit budgets are prepared in such a manner that the budget surpluses during the earlier period of inflation are balanced with deficits.

The excess of public expenditure over revenues are financed through public borrowings. The cyclically balanced budget can stabilize the level of business activity. During inflation and prosperity, excessive spending activities are curbed with budgetary surpluses while budgetary deficits during recession with raising extra purchasing power.

This policy is favored on the following account:
(i) The government can easily adjust its finances according to the needs;

(ii)This policy works smoothly in all times like depression, inflation, boom and recession;

(iii) Cyclically balanced budget simply ensures stability but gives no guarantee that the system will get stabilized at the level of full employment.

3. Fully Managed Compensatory Budget:
This policy implies a deliberate adjustment in taxes, expenditures, revenues and public borrowings with the motto of achieving full employment without inflation. It assigns only a secondary role to the budgetary balance. It lays down the emphasis on maintenance of full employment and stability in the price level. With this principle, the growth of public debt and the problem of interest payment can be easily avoided. Thus, the principle is also called 'functional finance.'

The fully managed compensatory budget has been criticized on the following
(i) It considers that the government should give blanket guarantee against unemployment.

(ii) This policy is not automatic.

(iii) It brings political upheavals as it delays the implementation of appropriate fiscal measures.

(iv) A country is burdened with debt in the long run period.

(v) This policy is a prolonged lag which in practice has a disturbing effect on the economy.

B. Taxation:

Taxation is a powerful instrument of fiscal policy in the hands of public authorities which greatly effect the changes in disposable income, consumption and investment. An anti- depression tax policy increases disposable income of the individual, promotes consumption and investment. Obviously, there will be more funds with the people for consumption and investment purposes at the time of tax reduction.

This will ultimately result in the increase in spending activities i.e. it will tend to increase effective demand and reduce the deflationary gap. In this regard, sometimes, it is suggested to reduce the rates of commodity taxes like excise duties, sales tax and import duty. As a result of these tax concessions, consumption is promoted. Economists like Hansen and Musgrave, with their eye on raising private investment, have emphasized upon the reduction in corporate and personal income taxation to overcome contractionary tendencies in the economy.

Now, a vital question arises about the extent to which unemployment is reduced or mitigated if a tax reduction stimulates consumption and investment expenditure. In such a case, reduction of unemployment is very small. If such a policy of tax reduction is repeated, then consumers and investors both are likely to postpone their spending in anticipation of a further fall in taxes. Furthermore, it will create other complications in the government budget.

Anti-Inflationary Tax Policy:

An anti-inflationary tax policy, on the contrary, must be directed to plug the inflationary gap. During inflation, fiscal authorities should not retain the existing tax structure but also evolve such measures (new taxes) to wipe off the excessive purchasing power and consumer demand. To this end, expenditure tax and excise duty can be raised.

The burden of taxation may be raised to the extent which may not retard new investment. A steeply progressive personal income tax and tax on windfall

gains is highly effective to curb the abnormal inflationary pressures. Export should be restricted and imports of essential commodities should be liberated.

The increased inflow of supplies from origin countries will have a moderate impact upon general prices. The tax structure should be such which may impose heavy burden on higher income group and vice versa. Therefore, proper care must be taken that the government policies should not bring violent fluctuations and impede economic growth. To sum up, despite certain short-comings of taxation, its significance as an effective anti-cyclical and growth inducing investment cannot be forfeited.

C. Public Expenditure:

The active participation of the government in economic activity has brought public spending to the front line among the fiscal tools. The appropriate variation in public expenditure can have more direct effect upon the level of economic activity than even taxes. The increased public spending will have a multiple effect upon income, output and employment exactly in the same way as increased investment has its effect on them. Similarly, a reduction in public spending, can reduce the level of economic activity through the reverse operation of the government expenditure multiplier.

(i) Public Expenditure in Inflation:

During the period of inflation, the basic reason of inflationary pressures is the excessive aggregate spending. Both private consumption and investment spending are abnormally high. In these circumstances, public spending policy must aim at reducing the government spending. In other words, some schemes should be abandoned and others be postponed. It should be carefully noted that government spending which is of productive nature, should not be shelved, since that may aggravate the inflationary dangers further.

However, reduction in unproductive channels may prove helpful to curb inflationary pressures in the economy. But such a decision is really difficult from economic and political point of view. It is true, yet the fiscal authority can vary its expenditure to overcome inflationary pressures to some extent.

(ii) Public Expenditure in Depression:

In depression, public spending emerges with greater significance. It is helpful to lift the economy out of the morass of stagnation. In this period, deficiency of demand is the result of sluggish private consumption and investment

expenditure. Therefore, it can be met through the additional doses of public expenditure equivalent to the deflationary gap. The multiplier and acceleration effect of public spending will neutralize the depressing effect of lower private spending’s and stimulate the path of recovery.

D. Public Works:

Keynes General Theory highlighted public works programme as the most significant anti-depression device. There are two forms of expenditure i.e., Public Works and ‘Transfer Payments. Public Works according to Prof. J.M. Clark, are durable goods, primarily fixed structure, produced by the government.

They include expenditures on public works as roads, rail tracks, schools, parks, buildings, airports, post offices, hospitals, irrigation canals etc. Transfer payments are the payments such like interest on public debt, subsidy, pension, relief payment, unemployment, insurance and social security benefits etc. The expenditure on capital assets (public works) is called capital expenditure.

Keynes had strong faith in such a programme that he went to the extent of saying that even completely unproductive projects like the digging up of holes and filling them up are fully admissible.

Public works are supported as an anti-depression device on the following grounds:

(i) They absorb hitherto unemployed workers.

(ii) They increase the purchasing power of the community and thereby stimulate the demand for consumption goods.

(iii)They help to create economically and socially useful capital assets as roads, canals, power plants, buildings, irrigation, training centres and public parks etc.

(iv) They provide a strong incentive for the growth of industries which are generally hit by the state of depression.

(v) They help to maintain the moral and self respect of the work force and make use of the skill of unemployed people.

(vi) The public works do not have an off setting effect upon private investment because these are started at a time when private investment is not forthcoming.

The above stated points are, therefore, the evidence that public works programme fully satisfies, the main criteria as laid down for public expenditure. However, this form of public expenditure is subject to certain limitations and practical difficulties. Some of these are listed as under.

1. Difficult Forecasting:
The effectiveness of public works programmes always rests upon accurate forecasting of the depression or boom. But prediction of accurate forecasting is very difficult.

2. Timing of Public Works:
Another serious problem relates to the timing of public works with the moment of cycle. Due to lack of accurate forecasting, proper timing is neither feasible nor possible. Thus this factor along undermines the significance of public works as an instrument of stabilization.

3. Delay in starting:
Public works programmes are not something which can be started immediately. Actually, it is a long term programme which requires proper planning with regard to the finance and engineering. In this way, delay is the natural cause. Dernburg and McDougal have rightly noticed, "public works are, in short, clumsy and slow moving requiring time to get ready and time to turn off."

4. Scarcity of Resources:
The undertaking of public works programme may pose a serious threat due to non-availability of resources. It is likely that scarcity of resources may further aggravate the crisis instead of giving the pace of smoothness.

5. Limited Scope of Employment:
The public works programme is not capable of assuring job to all cadres of unemployed workers. Such works are only started to absorb unskilled and semi-skilled workers and not the specialised.

6. Misallocation of Resources:

As the slump gets deepened, there is wide spread unemployment of manpower and equipment. Generally, public works are located in only few selected areas. Thus, they may prove to be inadequate to cope with the requirements. Again, immobility in factors of production may also prevent the economic utilization of available resources. As a result, they reduce the efficiency of public works programme.

7. Burden of Public Debt:

The public works programme, generally, are financed through borrowing during depression. This will saddle the country with a heavy burden of repayment of principle amount and interest therein.

8. Cost Price Maladjustments:

The public works programme may perpetuate cost price maladjustments in heavy industries where public expenditure is concentrated. During the period of boom, wages and prices in construction industries have a strong upward tendency while in recession or depression, prices move downward, wages and costs remain sticky relatively. In short, such distortion in cost price structure brings more instability in the economy.

9. Effect on Private Enterprise:

In certain areas, the construction programmes undertaken by the public agencies may complete with private investment. As a result, the later is driven out of business. In such a case, public works will prove to be self-off setting and the aggregate demand will possibly fail to increase.

10. Control over Public Works:

The success of public works mostly depends on the nature of control over them. If public works are controlled by the central authority, delay is likely to arise in selected projects.

11. Political Considerations:

Public works are often started in democratic countries in certain areas not on account of economic reasons, but the political pressures at national, state and local levels sway the government decisions. Consequently, the economic utility of such public works remains very limited.

E. Public Debt:

Public debt is a sound fiscal weapon to fight against inflation and deflation. It brings about economic stability and full employment in an economy.

The government borrowing may assume any of the following forms mentioned as under:

(a) Borrowing from Non-Bank Public:

When the government borrows from non-bank public through sale of bonds, money may flow either out of consumption or saving or private investment or hoarding. As a result, the effect of debt operations on national income will vary from situation to situation. If the bond selling schemes of the government are attractive, the people induce to curtail their consumption, the borrowings are likely to be non inflationary.

When the money for the purchase of bonds flows from already existing savings, the borrowing may again be non-inflationary. Has the government not been borrowing, these funds would have been used for private investment, with the result that the debt operations by the government will simply bring about a diversion of funds from one channel of spending to another with the similar quantitative effects on national income.

If the government bonds are purchased by non bank individuals and institutions by drawing upon their hoarded money, there will be net addition to the circular flow of spending. Consequently, the inflationary pressures are likely to be created. But funds from this source are not commonly available in larger quantity. Its main implication is that borrowings from non bank public is more advantageous in an inflationary period and undesirable in a depression phase. In short, the borrowing from non bank public are not of much significant magnitude whether it comes out of consumption, saving, private investment or hoarding.

(b) Borrowing from Banking System:

The government may also borrow from the banking institutions. During the period of depression, such borrowings are highly effective. In this period, banks have excessive cash reserves and the private business community is not willing to borrow from banks since they consider it unprofitable.

When unused cash lying with banks is lent out to government, it causes a net addition to the circular flow and tend to raise national income and employment. Therefore, borrowing from banking institution have desirable

and favourable effect specially in the period of depression when the borrowed money is spend on public works programmes.

On the contrary, borrowing from this source dry up almost completely in times of brisk business activities i.e. boom. Actually, demand is very high during inflation period, since profit expectation is high in business. The banks, being already loaded up and having no excess cash reserves. Find it difficult to lend to the government. If it is done, it is only through reducing their loans somewhere else.

This leads to a fall in private investment. As the government spending is off-set by a reduction in private investment, there will be no net effect upon national income and employment. In nut shell, borrowing from banking institutions have desirable effect only in depression and is undesirable or with a neutral effect during inflation period.

(c) Drawing from Treasury:
The government may draw upon the cash balances held in the treasury for financing budgetary deficit. It demonstrates dishoarding resulting in a net addition in the supply of money. It is likely to be inflationary in nature. But, generally, there are small balances over and above what is required for normal day to day requirements. Thus, such borrowings from treasury do not have any significant result.

(d) Printing of Money:
Printing of money i.e. deficit financing is another method of public expenditure for mobilizing additional resources in the hands of government. As new money is printed, it results in a net addition to the circular flow. Thus, this form of public borrowing is said to be highly inflationary.

Deficit financing has a desirable effect during depression as it helps to raise the level of income and employment but objection is often raised against its use at the time of inflation or boom. Here, it must be added that through this device, the government not only gets additional resources at minimum cost but can also create appropriate monetary effects like low interest rates and easy money supply.

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Economic Environment

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