Fiscal Policy

Meaning

Fiscal policy is one of the key tools that governments attempt to regulate and influence the economy to achieve Macroeconomics Goal. In simple words, Fiscal policy refers the use of government spending and tax policy to influence the path of the economy over time. It means the use of taxation and public expenditure by the government for stabilization or growth of the economy. n other words, Fiscal policy refers to the budgetary policy of the government, which involves the government controlling its level of spending and taxation within the economy. It is the sister strategy to monetary policy.

Types of Fiscal policy

There are two main types of fiscal policy. They are:

1. Neutral Fiscal policy: Fiscal policy is said to be neutral when the level of government spending in relation to tax revenue is stable over time. This type of policy is usually undertaken when an economy is in equilibrium- neither rapidly expanding nor contracting. In this instance, government spending is fully funded by tax revenue, which has a neutral effect on the level of economic activity.

2. **Discretionary fiscal policy:** Discretionary fiscal policy refers to government fiscal policy that alters government spending or taxes. Its purpose is to expand or shrink the economy as needed. It has two sub-types as:

(**i) Expansionary Fiscal Policy:** Discretionary fiscal policy is said to be Expansionary when the government spends more money than its revenue collected through taxes. This type of fiscal policy is usually undertaken during recessions to increase the level of economic activity.

(ii) Contractionary Fiscal Policy: Discretionary fiscal policy is said to be Contractionary when government spending is lower than tax revenue. This type of Fiscal policy is undertaken to pay down government debt and to curb inflation.

Objectives of Fiscal policy

The objective of fiscal policy is to maintain the condition of full employment, economic stability and to stabilize the rate of growth. General objectives of Fiscal Policy are given below:

1. Full employment: The first and foremost objective of fiscal policy in a developing economy is to achieve and maintain full employment in an economy. In such countries, even if full employment is not achieved, the main motto is to avoid unemployment and to achieve a state of near full employment. Therefore, to reduce unemployment and under-employment, the state should spend sufficiently on social and economic overheads. These expenditures would help to create more employment opportunities and increase the productive efficiency of the economy

2. Price stability: Various classes of society such as consumers, laborers and employees, agriculturists, producers, traders, etc. are affecting by fluctuation in prices. The general public is adversely affected by increasing prices. The fiscal policy endeavors to bring stability in prices by removing demerits of increase/decrease in prices. The impact of the price increase can be reduced by providing subsidy or decreasing taxes

3. Accelerating the rate of economic development: Primarily, fiscal policy in a developing economy, should aim at achieving an accelerated rate of economic growth. Therefore, fiscal measures such as taxation, public borrowing and deficit financing etc. should be used properly so that production, consumption and distribution may not adversely affect. It should promote the economy as a whole which in turn helps to raise national income and per capita income.

4. Optimum allocation of resources: Fiscal measures like taxation and public expenditure can greatly affect the allocation of resources in various occupations and sectors. Public expenditure in the form of subsidies and incentives can favorably influence the allocation of resources in the desired channels. For example, tax exemptions and tax concessions may help a lot in attracting resources towards the favored industries. On the contrary, high taxation may draw away resources in a specific sector.

5. Equitable distribution of income and wealth: A welfare state should provide social justice by giving equitable distribution of income and wealth. Fiscal policy can serve as an effective means of achieving this much desired goal of socialism in developed as well as developing countries. Progressive tax system can be of much use in realizing this objective. Moreover, public expenditure helps in redistributing income from the rich to the poor section of the society

6. Economic stability: Economic stability is another prime aim of a sound fiscal policy. This goal implies maintenance of full employment with relative price stabilization. Inflation should be curbed and deflation should be avoided. In short, economic growth and stability are the twin objectives jointly pursued by a developing country's fiscal policy. The forces stimulating growth process should be given a boost at a time while inflationary pressures are to be curbed. Fiscal measures promote economic stability in the face of short-run international cyclical fluctuations. These fluctuations cause variations in terms of trade, making the most favorable to the developed and unfavorable to the developing economies. Therefore, fiscal policy plays a leading role in maintaining economic stability in the face of internal and external forces.

7. Capital formation: The fiscal policy also aims at increasing the rate of investment in the private and public sector. The rate of capital formation in developing countries is very low due to unemployment and low per capita income. The vicious circle of poverty is main the problem of these countries. Therefore, fiscal policy is adopted in such a way that it reduces consumption and encourages savings is used to reduce undesirable consumption in developed countries

From the above discussion, it follows that the objectives of fiscal policy are not conflicting but complementary to each other.

Components of Fiscal policy

All the decisions taken by government in terms of taxation, resource mobilization and expenditure comprise the Fiscal Policy. There are four key components of Fiscal Policy are as follows:

1.Taxation Policy: The government tries to keep the taxes in nature and with the help of direct and indirect taxes controls, The government generates its revenue by imposing both indirect taxes and direct taxes at the same time maintain Price stability . Thus, it is important for the government to follow a judicial system for taxation and impose correct tax rates such as progressive tax. This is because of two reasons:

(a)The higher the tax, lower the purchasing power of the people. This will lead to a decrease in investment and production.

(a) The lower tax will leave more money with people that lead to high spending and thus higher inflation

2. Expenditure Policy: Expenditure policy of the government deals with revenue and capital expenditures. Capital Expenditures of the government include acquisition of long-term assets, such as facilities or manufacturing equipment etc, which will generate business or additional profits to government. Revenue Expenditures are those expenditures which don't create any productive assets such as interest paid by the Government of India on all the internal and external loans or pension and salaries of government employees.

3. Investment and Disinvestment **Policy**: Investment and Disinvestment Policy refers to investment in the form of FDI or FII in an economy from outside the country or disinvestment of government holding to public or private shares.

4. Debt / Surplus Management: If the government received more than it spends, it is called surplus. If government spends more than income, then it is called deficit. To fund the deficit, the government has to borrow from domestic or foreign sources. It can also print money for deficit financing

Role of Fiscal Policy in Developing Economy

The main goal of fiscal policy in a newly developing economy is the promotion of the highest possible rate of capital formation. The fiscal policy in developing economy should apparently be conducive to rapid economic development. Developing Economy, fiscal policy can no longer remain a compensatory fiscal policy. It has a tough role to play in a developing economy and has to face the problem of growth-cum-stability. The Roles of Fiscal Policy in Developing Economy are discussed as below:

1. Resource Mobilization: Owing to acute poverty, the marginal propensity to consume is very high in developing economies. As a result the level of saving is very low in these economies. Therefore fiscal policy has an important role to play in mobilizing saving for capital formation through taxation and public borrowing. It can also influence capital formation and savings in the private sector through granting of various tax concessions and subsidies.

2. Development of Private Sector: In a developing economy private sector forms an important constituent of the economy. The production and productivity of private sector can be influenced by fiscal policy. Tax relief, rebates, subsides may be granted to boost up the productive activity in the private sector. Fiscal tools and measures can be used to activate capital market to ensure availability of adequate resources for the private sector.

3. Optimization of Resources Allocation: In developing economies, fiscal tools can be utilized to effect optimum allocation of resources. Very often resources in private sector are directed towards the production of goods which cater to the requirement of richer section of society. Fiscal tools can be employed to allocate the mobilized resources in desirable channels of investment. Thus, process of reallocation can be done by various tax incentive measures and subsidy programmes.

4. Creation of Social and Economic Overheads: In developing economics, there is the lack of proper development of basic infrastructures which are vital requirements for economic development. Provision of social overheads like education and health service will directly enhance the productive capacity of the people. Expenditure incurred for the provision of economic overheads like transport facilities, power generation and telecommunication facilities which will speed up the process of industrialization. Hence, government has to provide investments on Building of social and economic overheads through fiscal measures of taxation and expenditure programmes.

5. Balanced Regional Development: Developing economies face the problem of regional imbalance in the matter of economic development. Fiscal tools like tax concession, tax holiday, subsidies, concessions in infrastructure utilization etc., can be given to private investors to attract private investment in these backward geographical areas as part of the strategies for balanced growth.

6. Economic Stability: Fiscal tools such as taxation and expenditure programmes can be utilized as an effective tool to control cyclical fluctuations arising during the process of economic development. Taxation is an effective instrument to deal with inflationary and deflationary situations.

7. Reduction of Inequality: Provision of equality in income wealth and opportunities form an integral part of economic development in developing economics. Fiscal policy has an important role to play in reducing inequality.

Instruments of taxation must be used as a means to bring about redistribution of income. The various fiscal measures directed towards reduction of inequality in income, wealth and opportunity are: progressive taxation of income and property, imposition of heavy taxation on luxury goods, tax exemption or concession to commodities of mass consumption, government expenditure on relief programmes, and provision of essential commodities at subsidized price through fair price shops to the poor etc.

Differences between Fiscal Policy and Monetary Policy

1. While fiscal policy is concerned with how money is spent and collected by the government, monetary policy is concerned with the overall supply of money within the economy.

2. Fiscal policy is usually set by the executive and legislative functions. Monetary policy is generally determined by central banks.

3. Governments adjust fiscal policy by changing levels of taxation and spending in order to stimulate (or discourage) consumer spending and maintain healthy levels of employment and inflation. The key metric here is aggregate demand.

4. Central banks adjust monetary policy by buying and selling treasury bonds to expand or contract the amount of currency in circulation, and by raising or lowering the interest rate and reserve ratio (i.e. the amount of money banks are required to hold onto at any given time) in order to stimulate (or discourage) lending by banks