Chapter II unit 3

Fiscal Policy

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Fisc → Fiscal

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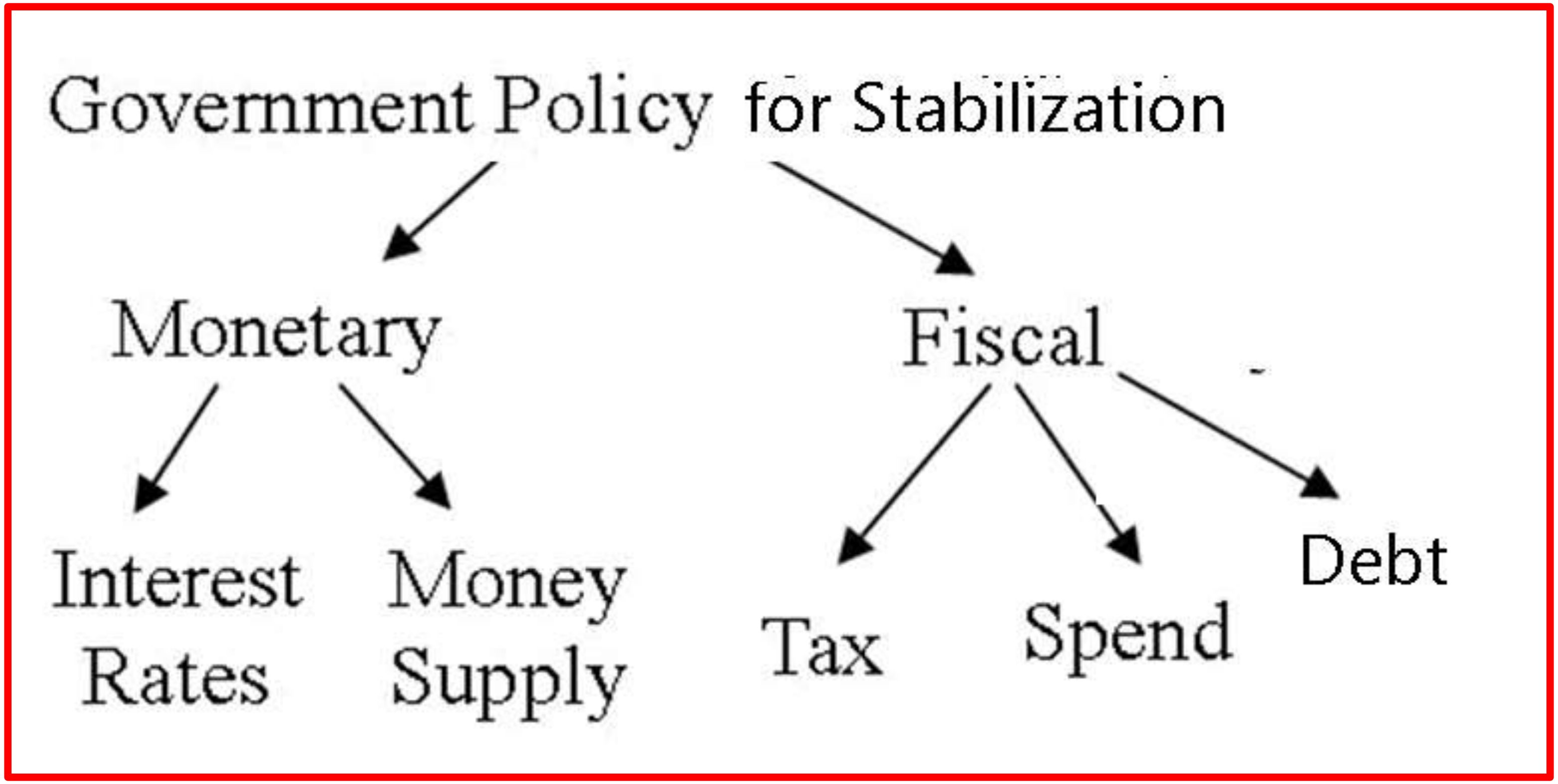
Government Policy for Stabilization
Monetary
Fiscal
Interest Rates
Money Supply
Tax
Spend
Debt

Governments influence the economy

- by changing the level and types of taxes,
- the extent and composition of spending, and
- the degree and form of borrowing.

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Budget

- **Public Finance transformed into fiscal policy**

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From

- Microeconomic point of view

to

- The macroeconomic perspective

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Aggregate economic activity of governments

- Aggregate expenditure
- Taxes
- Transfers
- Government debts and deficits
- **Effects on aggregate economic variables** such as total output, total employment, inflation, overall economic growth etc .

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Adam Smith and the Classical Economists

- Believed that the economy was always tending toward a full employment equilibrium and stable prices

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What does laissez-faire mean?

- Leave alone, let the economy correct problems itself

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What are the four phases of the business cycle?

- Trough
- Recovery
- Peak
- Recession

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Fiscal Policy

- Before 1930
- Great depression and the consequent instabilities
- After 1930
- Global financial crises and recession
- 2008

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What is a fiscal policy?

- The manipulation of government purchases, transfer payments, taxes, and borrowing in order to positively influence the economy

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Definition

- Policy concerning the use of state treasury or the government finances to achieve the macro-economic goals”

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Definition

- "Government policy of changing its taxation and public expenditure programmes intended to achieve its objectives".

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Or

“Government uses its expenditure and revenue program to produce desirable effects on National Income , production and employment

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Main economic goals of fiscal policy

- Achievement and maintenance of Full employment (no cyclical unemployment)
- Economic growth (increase production /GDP) with actions on the supply side to improve infrastructure or education
- Price stability (keep inflation under control)
- Equitable distribution of income and wealth

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Fiscal policy can be effective

- **Fiscal policy during abnormal times**
  - **The Great Depression—fiscal policy may be able to stimulate aggregate demand.**
  - **Wartime—during World War II real GDP increased dramatically.**

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Remember !

Not all fiscal policy is deliberate

Non-Discretionary Fiscal Policy

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What are Automatic stabilizers?

Structural features of government spending and taxation smooth out fluctuations in booms and busts

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Automatic stabilizers

- The stronger and more effective the automatic stabilizers are, the less need there is for discretionary fiscal policies

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Automatic stabilizers

- are mechanisms built into government budgets,
- they do not require legislative action and respond quickly to economic downturns

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How ?

- Automatic stabilization occurs (offset fluctuations) through automatic adjustments in government expenditures and taxes without any deliberate governmental action.

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Built-in or automatic stabilisers

- that operate without requiring explicit action by policy-makers
- best-known automatic stabilizers are progressively graduated corporate and personal income taxes, and transfer systems such as unemployment insurance and welfare.

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Most taxes have a stabilizing effect

- because
  they automatically move with economic growth.

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During recessions

- Tend to increase government deficits (or reduce surplus) through lower taxes and higher welfare payments

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During inflationary periods:

- Tend to increase government surpluses (or reduce deficits) through higher taxes and lower welfare payments

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How Automatic or Built-in Stabilizers work?

- Tax receipts: Increase as real GDP increases, so the economy slows
- Transfer Payments : Decrease as real GDP increases, but increase when the economy slows so GDP and AD increase.

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However,

- **Do not fully correct the economy, only reduces the severity of fluctuations**
- **Useful when economy is operating around full employment**

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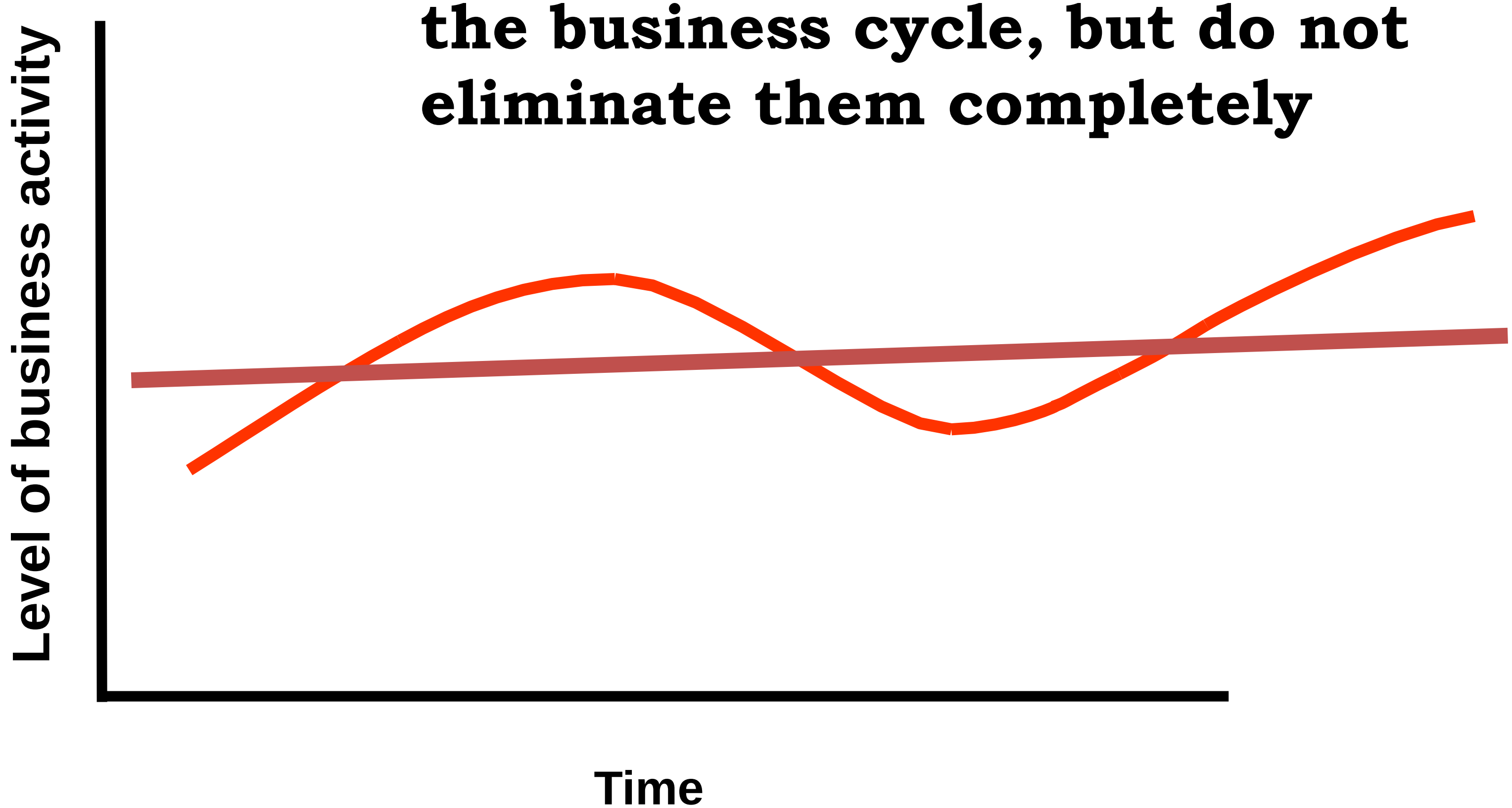
Automatic or Built-in Stabilisers

Flatten out the fluctuations in the business cycle, but do not eliminate them completely



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Should we rely on automatic stabilizers?

- **The stronger and more effective the automatic stabilizers are, the less need there is for discretionary fiscal policies**

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Instruments of Fiscal Policy

- The Keynesian school
- The ability of fiscal policy to influence output by affecting aggregate demand makes it a potential instrument for stabilization of the economy.

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Discretionary Fiscal Policy

- The discretionary changing of government expenditures or taxes
- to achieve national economic goals, such as high employment with price stability

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- **Fundamental equation of national income accounting that measures the output of an economy**

$$\mathbf{GDP = C + I + G + NX.}$$

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What is a discretionary fiscal policy?

is the realm of fiscal policy.

- High employment (low unemployment)
- Price stability
- Economic growth
- Improvement of international payments balance

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Discretionary Fiscal Policy

- The deliberate manipulation of taxes and spending by government
- for the purpose of altering real GDP and employment, controlling inflation and stimulating economic growth

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Let us repeat

- The discretionary changes in government expenditures and/or taxes in order to achieve certain national economic goals
- The deliberate manipulation of taxes and spending by government for the purpose of altering real GDP and employment, controlling inflation and stimulating economic growth

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What is an expansionary fiscal policy?

- An increase in government purchases, decrease in net taxes, or some combination of the two
- aimed at increasing aggregate demand
- to reduce the effects of recession,
- i.e. boost GDP and
- reduce unemployment

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Expansionary fiscal policy

- Designed to stimulate the economy during the contractionary phase of a business cycle or
- When there is an anticipation of a business cycle contraction.

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When will the government use expansionary fiscal policies?

- To stimulate the economy when unemployment is greater than the natural rate

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- **Aggregate production is less than what would be produced with full employment of resources**

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What do they do?

- Increasing aggregate expenditures
- And aggregate demand
- Through an increase in all types of government spending

and / or

- A decrease in taxes.

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Pump priming'
Vs
'Compensatory spending'.

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Pump Priming (acknowledge internet sources)

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Government Expenditure as an Instrument of Fiscal Policy (i)

- Current expenditures
- Capital expenditures
- Transfer payments

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Government expenditure

- Directly generate incomes to labour and suppliers of materials and services.
- Indirect effect in the form of working of multiplier.
- Surplus capacity
- Primary employment in public works
- Induce secondary and tertiary employment,

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Decrease Spending

1. Less money in economy
2. Less money = less demand
3. Less demand = lower inflation

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Taxes as an Instrument of Fiscal Policy

- changes in government revenues
- in rates of taxes aimed at encouraging or restricting private expenditures on consumption and investment
- size of disposable income determines aggregate demand

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Increase Taxes

- ✓ People have less money to spend
- ✓ Less money = less demand
- ✓ Less demand = lower inflation

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Decreasing Taxes

1. Gives people more money to spend
2. More money = more demand
3. More demand = more production
4. More production = more jobs
5. More jobs = more demand etc. etc.

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Increase Spending

1. Increases demand for goods
2. More demand = more production
3. More production = more jobs
4. More jobs = more demand etc. etc.

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- **Structure of tax rates is varied**
- **During recession and depression tax policy is framed to encourage private consumption and investment**
- **A general reduction in income taxes**
- **Low corporate taxes**

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During inflation

- **new taxes are levied**
- **rates of existing taxes are raised**
- **reduce disposable incomes**
- **wipe off the surplus purchasing power.**

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Public Debt as an Instrument of Fiscal Policy

- Public borrowing and debt repayment is a potent weapon to fight inflation and deflation
- Public debt may be internal or external

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Market loans

- Government issues treasury bills and government securities of varying denominations and duration which are traded in debt markets
- Long-term capital bonds are floated and for meeting short-term government expenditure, treasury bills are issued

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Small savings

- Not negotiable and are not bought and sold in the market.
- Borrowing from the public
- Curtails the aggregate demand in the economy
- Repayments of debt
- Increase aggregate demand

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Demand-Side Fiscal Policy

- A change in consumption, investment, government purchases, or net exports can change aggregate demand and there fore shift the AD curve.
- A change in taxes can affect consumption or investment or both and there for can affect aggregate demand.

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Budget as an Instrument of Fiscal Policy

- Net effect of a budget on aggregate demand depends on the government's budget balance.
- Balanced
- Surplus
- Deficit

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A balanced budget

- leakages from the system – Taxes
- equal to the injections – Govt. expenditure

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- **A budget surplus**
- **Leakages exceed injections**
- **Negative net effect on aggregate demand**
- **A budget deficit**
- **Total injections exceed leakages from the government sector**
- **Budget deficit will add to the national debt**

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Recession

- Declining real income, as measured by real GDP simultaneously with a situation of rising unemployment.
- Fall in aggregate demand
- Demand-deficient recession
- Measure to close a 'recessionary gap'or contractionary gap

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What is the typical Keynesian policy during recessions?

- To use discretionary fiscal policies to stimulate the economy to a full employment equilibrium

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Refer Unit 2 Chapter 1

-
- **Equality of planned aggregate expenditures and output need not take place at full employment**
- **‘recessionary gap’.**
- **‘contractionary gap’**
- **Deflationary Gap**

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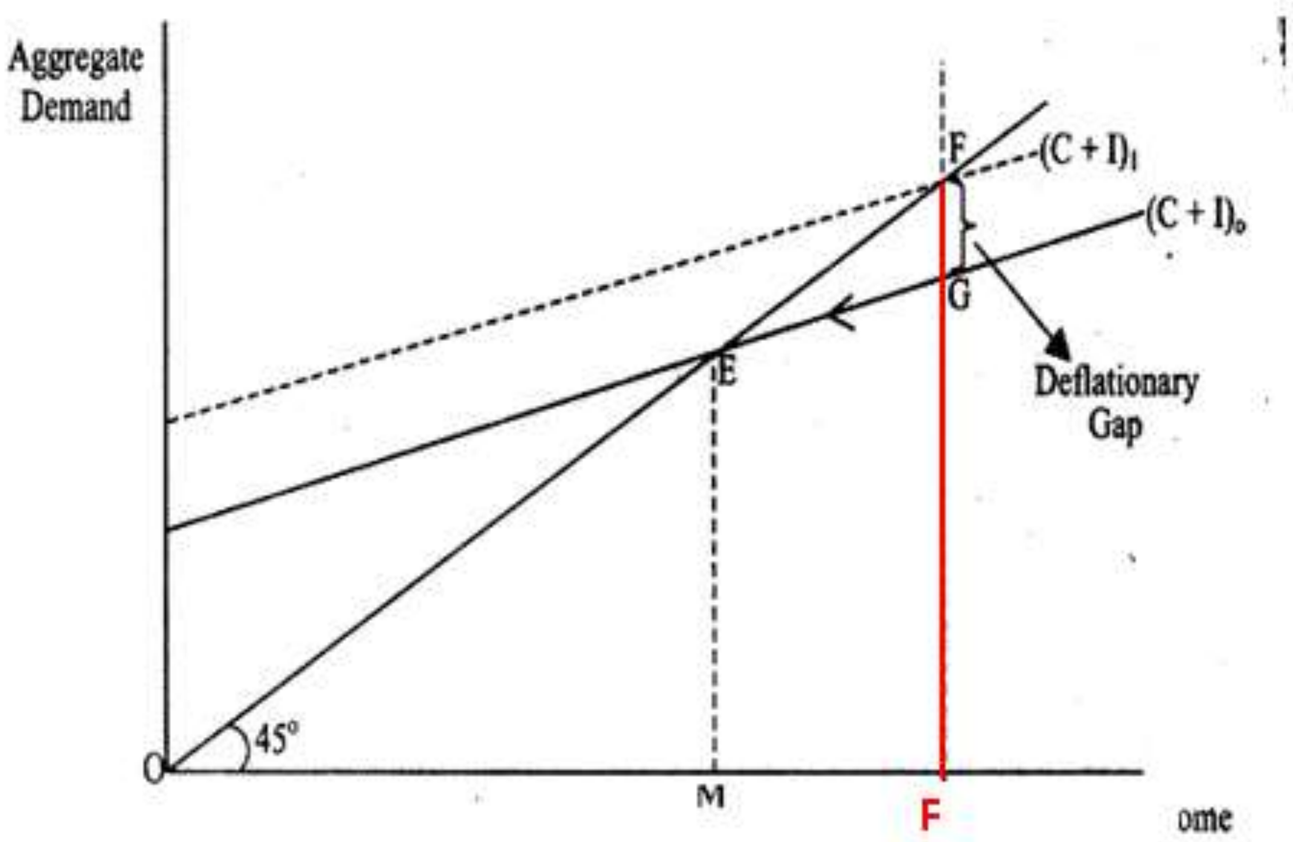
Occurs during contractionary phase



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- **Unplanned build-up of inventories of unsold goods**
- **Respond by cutting production and employment**
- **Leading to decrease in output and income**
- **Underemployment equilibrium is reached at E.**

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Deflationary gap

- Is a measure of the extent of deficiency of aggregate demand

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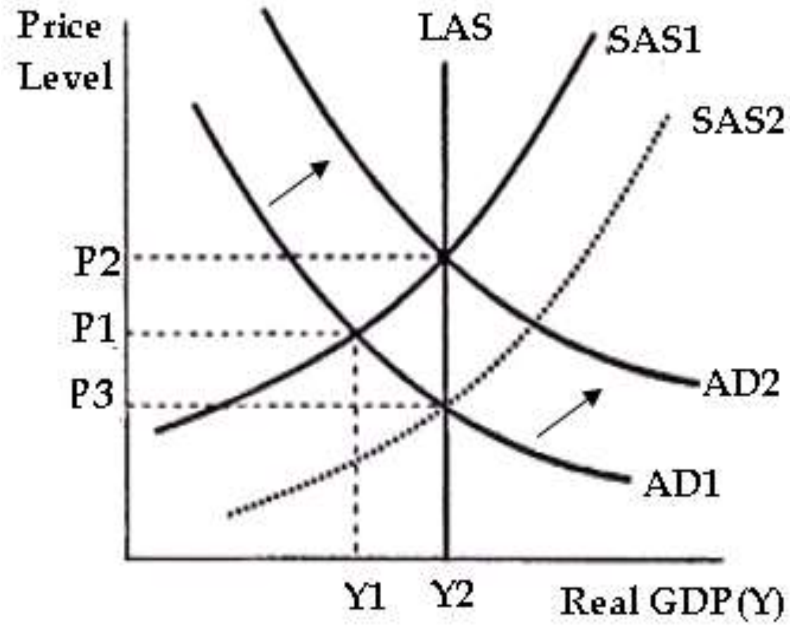
Expansionary Fiscal policy for Combating Recession



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Contractionary fiscal policy

- **Designed to restrain the levels of economic activity during an inflationary phase**
- **Or when there is anticipation of a business-cycle expansion which is likely to induce inflation.**

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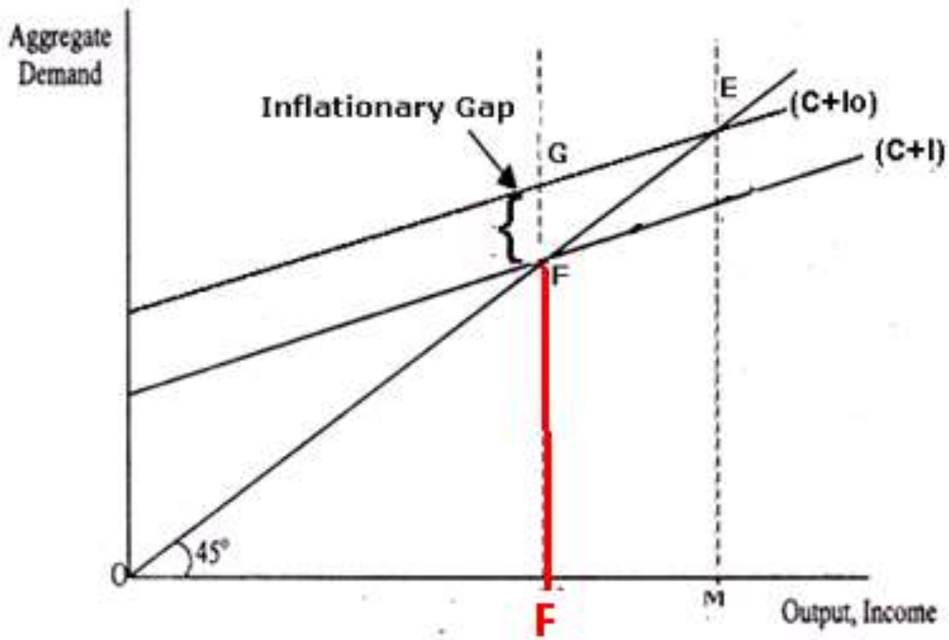
Overheated !!
Inflationary Gap



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How?

- Decreasing the aggregate expenditures and aggregate demand through a decrease in all types of government spending and/ or an increase in taxes
- Lead to a smaller government budget deficit or a larger budget surplus

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What is a contractionary fiscal policy?

- A decrease in government purchases, increase in net taxes, or some combination of the two aimed at reducing aggregate demand

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More

- Decreased government spending or
- higher taxes or
- a reduction in transfer payments
- in order to reduce inflation during a boom

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When will the government use contractionary fiscal policies?

- **To slow down the economy when inflation is more than desired**

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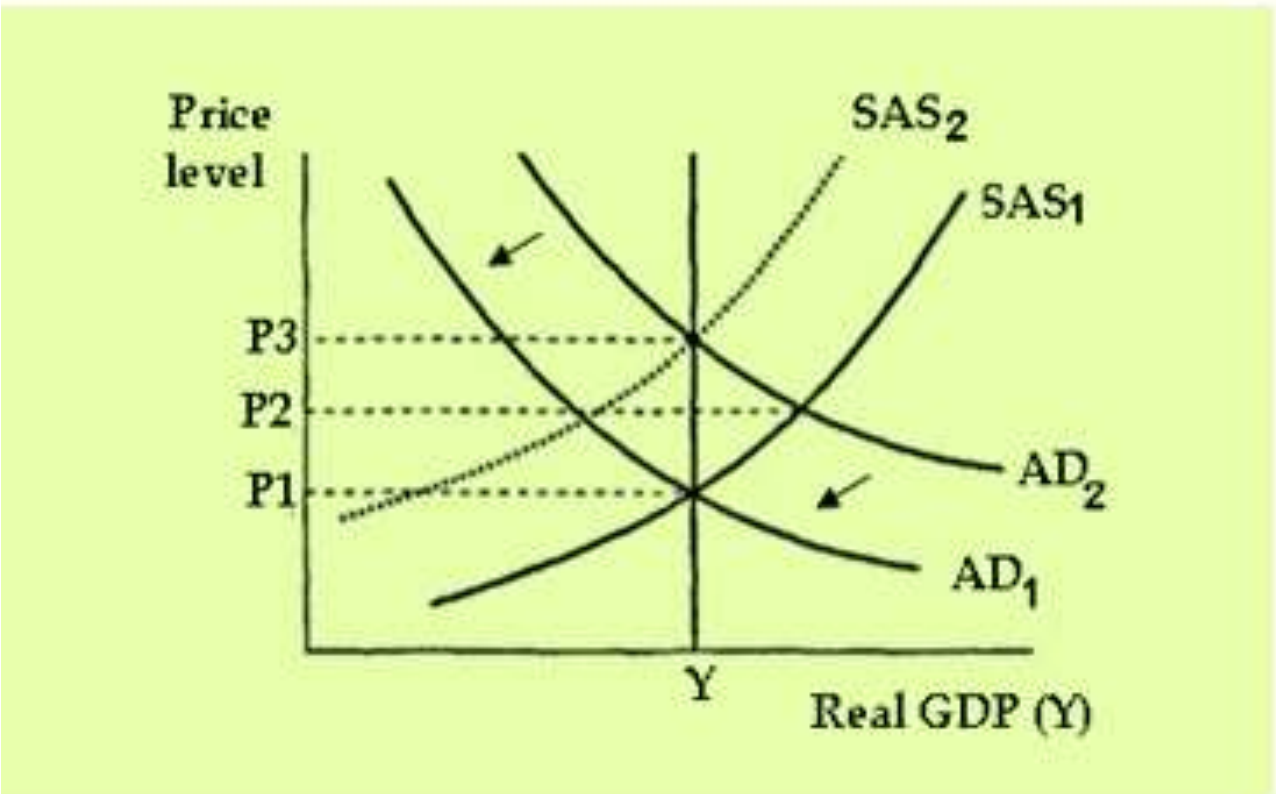
Economy –already at the natural level of real GDP and AD might shift from *AD* $_1$ to *AD* $_2$.



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Multiplier effect

The idea that an increase in spending by consumers, businesses, or government can cause larger changes in economic production.

This occurs because spending becomes someone else's income, which then generates more spending. The multiplier also works in reverse when spending decreases.

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Problem

- Rs.500 million gap between current output and full employment output, how much government spending is necessary to achieve full employment if MPC= .75
- Concept of spending multiplier
- = 1/1- MPC

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- **Required expenditure =**

  Desired change in AD/

  the spending multiplier

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Fisical Policy for Long-run Economic Growth

- Supply-side effects
- Eg.
- Infrastructure provision
- Human capital formation
- Research and development
- More

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Fisical Policy for Reduction in Inequalities of Income and Wealth

- A progressive direct tax system
- Indirect taxes can be differential:

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A carefully planned policy of public expenditure

- Targeted spending programmes
- Poverty alleviation programmes
- Free or subsidized medical care, education , housing, essential commodities etc. To improve the quality of living of poor
- Infrastructure provision on a selective basis

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A carefully planned policy of public expenditure

- Various social security schemes under which people are entitled to old-age pensions, unemployment relief, sickness allowance etc.
- Subsidized production of products of mass consumption

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- **Public production and/ or grant of subsidies to ensure sufficient supply of essential goods, and**
- **Strengthening of human capital for enhancing employability etc**

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High marginal taxes

- A strong deterrent to work save and invest

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Limitations of Fiscal Policy

- Different types of lags
- Recognition lag
- Decision lag
- Implementation lag
- Impact lag

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1. **The Data Lag**
2. **The Wait-And-See Lag**
3. **The Legislative Lag**
4. **The Transmission Lag**
5. **The Effectiveness Lag**

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Do lag effects influence discretionary fiscal policies?

- Yes, they weaken fiscal policies as a tool of economic stabilization

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- **Difficulties in changing spending and taxation policies**
- **Conflict between levels of government over appropriate policies**
- **Government borrowing puts upward pressure on interest rates.**

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- **People base their consumption decisions not just on current income but also on permanent income.**
- **If people view tax changes as only temporary, they will not have their desired effect**

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- **May at times be badly timed**
- **Are difficulties in instantaneously changing governments' spending and taxation policies**
- **Practically difficult to reduce government spending on various items**

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- **Public works cannot be adjusted easily**
- **difficulties of forecasting**
- **possible conflicts between different objectives of fiscal policy**
- **Supply-side economists '<u>fiscal measures will cause disincentives</u>'**

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- **Deficit financing result in prices spiraling beyond control.**
- **Increase is government borrowing creates perpetual burden**

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Crowding out

- **The increase in government expenditure will lead to the fall of private expenditure, thus resulting in a smaller multiplier effect on the equilibrium level of income.**
- **Underlying assumption:**

$$\Delta G\uparrow \;\Rightarrow\; \Delta r\uparrow \;\Rightarrow\; \Delta I\downarrow \;\Rightarrow\; \Delta Y\downarrow$$

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The crowding out effect

- is an economic theory arguing that rising public sector spending drives down or even eliminates private sector spending.

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- **The increase in interest rates that often accompany a deficit-financed fiscal stimulus may cause private investment and consumption in the economy to decrease.**
- **Therefore, any increase in AD from new government spending may be off-set by a decrease in private spending, which is crowded-out by higher borrowing costs**

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- **Private investments are sensitive to interest rates**
- **Lead to reduction in an economy's ability to self-correct from the recession**
- **During deep recessions, crowding-out is less likely to happen**

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- **Government's spending using up financial and other resources that would otherwise be used by private enterprises**
- **Increased government borrowing tends towards an increase in market interest rates**

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Governments can pay high interest

- Lenders always prefer lending to the government before lending to private borrowers because of the ‘safety’ factor of the government borrowing.

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- **This fall in fixed investment by businesses can hurt long-term economic growth**
- **The supply side, i.e., The growth of potential output.**
- **Political pressures**
- **Lack of coordination with monetary policy**

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- **Political constraints on tax policies**
- **Political Issues: Often times leaders act to get reelected not always to provide the best answer.**
- **Long time to have an effect (e.g. education) supply therefore inflation and no benefit**

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Developing countries

- The tax structure of the developing countries is narrow and rigid
- there is a tendency on the part of the people to invest their saving in immovable property and jewellery.
- .

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- **A sizable portion of developing countries is non-monetized, adversely affecting the success of fiscal policy**

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- **Lack of adequate data regarding income, expenditure, saving, investment, employment, etc. complicates the task of the state to formulate and implement of effective fiscal policy.**

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- **Administrative machinery responsible for execution of the fiscal policy is corrupt, incapable.**

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- **Fiscal policy needs to be coordinated with monetary policy.**

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