MA Economics, Semester IV, Paper II: Government Budgeting and Fiscal Choice

Topic: Fiscal policy, Meaning, Objective, Role in Developing Economies

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Meaning of Fiscal Policy:

Governmental activities before the Great Depression of the 1930s were minimal and, hence, the role of fiscal policy was extremely limited.

In fact, it was Keynes who popularized this great instrument of macroeconomic policy during the 1930s' Depression. Prior to Keynes' appearance in economic literature, classicists believed in minimal activities of the government in economic affairs and, hence, a small and balanced budget was considered to be an ideal one.

But Keynes' General Theory demolished all the classical ideas. Keynes prescribed state intervention and balanced budget to cure economic ills from which various European capitalist economies were suffering at that time. His policy prescription yielded dramatic results and, since then, fiscal policy became an all-important instrument of macroeconomic policy.

Fiscal policy is an integral part or organ of public finance. In ordinary words, fiscal policy refers to a policy that affects macroeconomic variables, like national income, employment, savings, investment, price level, etc.

Fiscal policy is **"a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment."**
Thus, fiscal policy involves the policy relating to taxation, government spending and borrowing programmes to affect macroeconomic variables.

The use of such fiscal policy measures may be grouped into two:

(i) Those which operate automatically— popularly known as automatic or built-in stabilizers

(ii) Those which are discretionary in the sense that the government takes deliberate action to manage aggregate demand—popularly called discretionary fiscal policy.

Automatic or Built-in Fiscal Policy-Automatic fiscal policy is a change in fiscal policy that is triggered by the state of the economy. Note that this kind of fiscal policy adjusts automatically and, hence, no explicit action by the government is needed.

Under automatic fiscal policy stabilizers, there occurs an automatic change in tax receipts and expenditures with the changes in income. During depression, as unemployment rises, income declines. As a result, tax receipts of the government decline. On the other hand, government expenditures rise.

Thus, tax receipts and expenditures have certain stabilizing forces that are automatic. There does not occur any deliberate action on the part of the government to influence aggregate demand. Once the change in economic activity takes place, receipts and expenditures change automatically.

ii. Discretionary Fiscal Policy:

On the other hand, discretionary fiscal policy is a policy action that is initiated by the authority. This type of fiscal policy may be used by the government rather deliberately.

Deliberate policy changes to influence the level of economic activity may be called discretionary fiscal policy. Discretionary fiscal policy entails a change in the government budget. Government deliberately alters tax schedules and various expenditure programmes.

Objectives of Fiscal Policy:

Fiscal policy refers to the government programmes of making both automatic and discretionary changes in taxation, public expenditure and borrowing in order to achieve the intended goals of economic growth, full employment, income equality and the stabilization of the economy in its growth path.

The basic objectives of fiscal policy—mainly in the context of developing countries—are enumerated:

i. Economic Growth:

One of the important long term goals of fiscal policy of mainly poor countries is economic growth since these countries lie in a state of perpetual poverty. In other words, fiscal policy aims at controlling long term disequilibrium and at maintaining equilibrium growth path.

Economic growth is largely conditioned by capital formation. To step up economic growth, capital formation has to be raised. Fiscal policy is a means through which investment can be stepped up. To ensure that economic growth is not hampered, the government must see that there is an adequate increase in public investment which produces a strong multiplier effect on the economy. Fiscal policy through its tax instrument should encourage more savings and investment and discourage consumption. A judicious tax-expenditure policy of the government will tend to promote investments in socially desirable lines of production.

Public borrowing may be justified on the ground of raising income level. It also releases financial resources for development. To ensure that growth of production is not hampered, the government has to see that there is an adequate increase in public investment which produces a favourable multiplier effect on the economy.

ii. Full Employment:

Attainment of full employment is a major short run goal of fiscal policy. Fiscal policy of government— changes in government expenditures and tax receipts— has great effects on unemployment, output, etc. An increase in government expenditure leads to a rise in the level of employment.

Actually, the government transfer expenditures, particularly public works programmes, are more effective in stimulating effective demand and, hence, the volume of employment. In fact, employment-oriented public expenditure programmes conducted by the Government of India round the year help generating additional employment and incomes.

Not only government expenditure but also taxation policy helps to attain the goal of full employment. A tax cut increases disposable income in the economy raising the level of demand to a level needed to absorb unemployed labour force.

Taxation policy has to be designed in such a way that it stimulates investment and consumption.

This will stimulate aggregate demand (C + I + G) and, consequently, the volume of employment. However, for political reasons, taxation policy often fails to achieve the desired goal. That is why a greater emphasis is placed on various public expenditure programmes to reduce the bogey of unemployed.

iii. Price Stability:

Another short run objective of fiscal policy is the attainment of the goal of price stability. Instability in price level, i.e., either inflation or deflation, produces some undesirable consequences. That is why the government prepares its budget in such a way that both inflation and deflation are controlled.

During prosperity or boom, a surplus budget and, during depression, a deficit budget is formulated. In other words, tax rate increase and reduction in government expenditures are recommended for controlling inflation and cut in tax rates and increase in government expenditure are recommended during deflation. It is to be kept in mind that, in the process of economic growth, some sort of inflation is bound to emerge. Fiscal policy must be designed in such a way that relative price stability— rather than absolute stability— constitutes the objective.

It is also to be remembered that there is a conflict between the two goals—full employment and price stability— of fiscal policy. Attainment of the goal of full employment may lead to instability in prices or attainment of the goal of price stability may lead to a high degree of unemployment. This kind of conflict was observed by A. W. Phillips.

He argued that a country may not reach the goal of full employment if it attaches too much importance to price stability. In other words, full employment is often associated with high prices or price stability is associated with a high degree of unemployment. Hence the conflict as well as the dilemma to the policy makers. This sort of conflict to some extent dampens the effectiveness of fiscal policy.

iv. Equity and Justice:

Modern welfare governments provide social justice by providing equitable distribution of income and wealth. Fiscal policy is an important instrument that aims at reducing income and wealth gaps between people. Government can use its tax- expenditure policies in such a way that income distribution can be made more equitable.

For this, it imposes newer taxes and raises tax rates in a progressive manner. On the other hand, it spends money for the persons who belong to the low income group. Thus, by taxing the rich at a progressive rate and spending those revenues for the betterment of the poor people, economic disparities between them can be minimized.

However, how far the effect of progressive taxes will percolate down to the poor strata of the society is a difficult question to answer. This is because money collected through taxes fall below the targeted amount due to corruption, tax evasion, etc. Since then, the goal of redistribution of income and wealth can be made in an equitable manner through various tax-expenditure programmes of the government.

Thus, it is clear that fiscal policy is an important instrument to achieve the goal of higher economic growth and stability by influencing aggregate demand. Further, its role in mitigating or reducing the level of unemployment and inequality cannot be disputed.

Role of Fiscal Policy in Developing Countries:

In developed countries, fiscal policy is designed to counter mainly cyclical fluctuations. Fiscal policy is also employed in these countries to reuse the rate of growth of income. Fiscal policy in developing countries, however, has a somewhat different role to play. This is because that though these countries experience economic fluctuations, its nature is different.

Firstly, not only fluctuations occur at a low level of income but also there is no scope for stable growth. Secondly, fluctuations are more prominent in the realm of output and price level rather than output and employment level. Due to the pre-eminence of the agricultural sector in these economies, supply becomes relatively inelastic and unemployment problem becomes severe.

But oscillations in income and price level tend to become more violent. Thirdly, because of the preponderance of the agricultural products in export trade, fluctuations get transmitted from the developed countries to the underdeveloped counterpart.

As foreign demand for the export is subject to frequent changes, the internal economy cannot remain free from such changes or random oscillations. Finally, the nature of inflation is different in developing countries. In view of these reasons, fiscal policy in poor countries has a special role to play.

Underdeveloped countries are entangled in the vicious circle of poverty. By breaking this impasse, a country can bring higher rate of growth. Thus, rapid economic growth seems to be the fundamental goal of fiscal policy in these countries.

But in the process of economic growth these economies experience inflationary rise in prices since these countries are inflation-sensitive countries. Truly speaking, economic stabilization cannot be separated from economic growth.

Thus, **'growth with stability'** is the most fundamental objective of fiscal policy in developing countries. This changes the nature of fiscal policy. In developed countries, fiscal policy becomes merely of a compensatory character. But in developing countries, it cannot be a compensatory one.
The main goal of fiscal policy in LDCs should be the increase in capital formation so that the vicious circle of poverty can be destroyed. Economic growth of a country greatly depends on capital accumulation. It is the scarcity of capital that causes underdevelopment.

Thus, by raising the rate of capital formation in these countries, a higher and rapid economic growth can be brought about. But because of the shyness of private capital in these poor countries, the government fills up the vacuum. Huge public expenditure is incurred to create physical infrastructure. By building up social overhead capital, LDCs can strike a higher growth rate.

Further, capital formation of higher order requires the raising of aggregate saving. It is the fiscal policy that can provide scope for raising the community saving.

In other words, fiscal policy has to be tailored in such a way that it not only raises overall saving but also lowers down the actual as well as potential consumption. Fiscal policy is, thus, an instrument that raises saving and capital formation, thereby resulting in a higher economic growth.

Fiscal policy has also to be employed in such a way that the existing scarce resources get channelized in socially productive sectors. Fiscal policy in these countries aims at diverting resources from unproductive sectors to socially necessary lines of development. In other words, fiscal policy is tied to developmental planning so that a higher economic growth can be achieved.

But fiscal policy is not only directed towards achieving higher economic growth alone. It aims at an equitable distribution of income and wealth which is a characteristic of all modern mixed poor economies. Existence of such inequality between the rich and the poor is a great social malaise.

In fact, benefits of higher economic growth can never lead to increase in social welfare unless equality is established. A proper fiscal policy can redistribute income and wealth in a society.

But at the same time it has to be borne in mind that the attainment of goals of higher economic growth and income equality is somewhat paradoxical. In other words, if the economy cries for higher economic growth, income inequality is bound to widen. Or if reduction in inequality is considered to be the primary goal, the goal of rapid economic growth will have to be sacrificed to some extent.

Hence the paradox. But the logic of this point is questionable. In fact, what is required is the conciliation of these two apparently contradictory goals. If well-balanced fiscal instruments are employed, a satisfactory reconciliation between the two fisc goals of higher economic growth and income equality and, hence, maximum social welfare, is not difficult to achieve.

Finally, fiscal policy has an additional role to play in LDCs which are inflation-sensitive countries. In the process of economic growth, inflation is bound to appear in these economies.

Fiscal policy, thus, has to be employed in such a way that a reasonable economic stability can be maintained, but not at the cost of the goal of higher economic growth. Growth-cum-stability seems to be the most important fiscal objective in developing economies.

Study Material Reference

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