

Fiscal policy- Meaning

A policy that influences changes in Government expenditure and taxes that are designed to achieve macroeconomic policy goals like Growth, employment, investment, inflation control, etc.

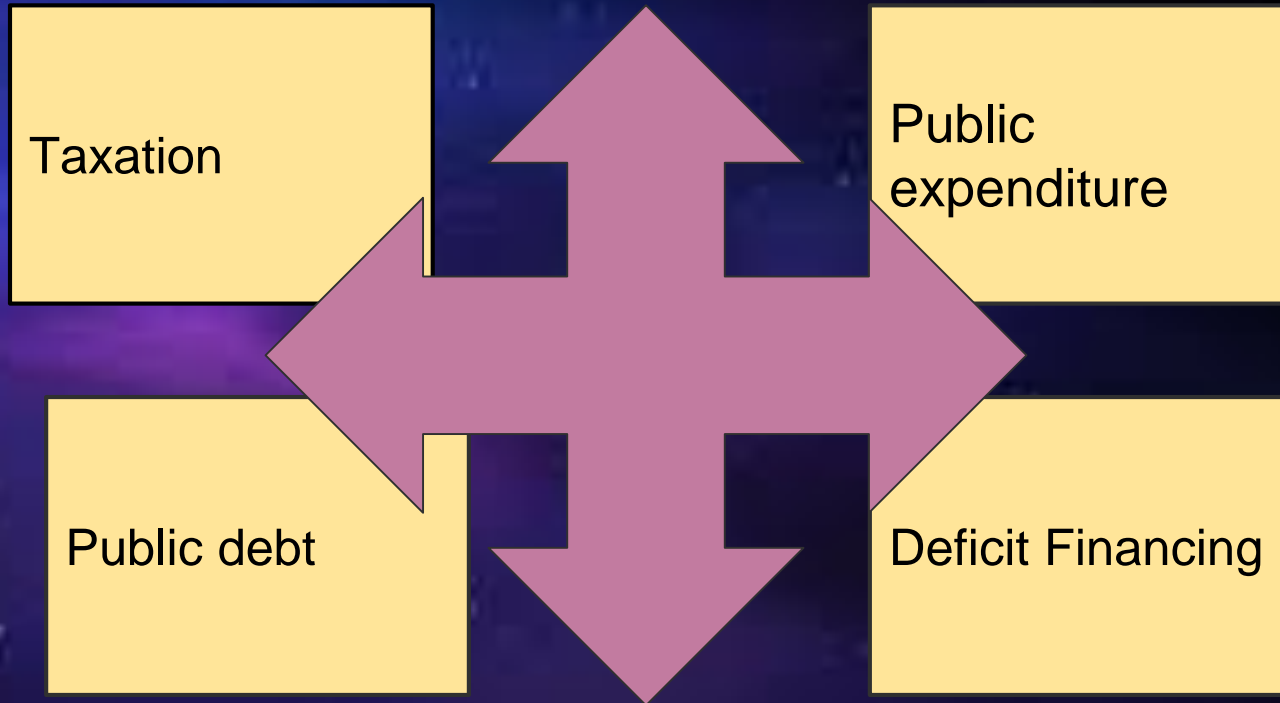


OBJECTIVES AND INSTRUMENTS

The main objectives are ;-

1. To achieve optimum allocation of resources
2. To increase effective demand and thereby to achieve full employment and maintain it
3. To ensure price stability.
4. To bring about greater equality in the distribution of income and wealth .

INSTRUMENTS



Taxation

Taxation is a powerful fiscal weapon in the hand of the government. Through taxation the government can influence production, consumption, distribution, and allocation of resources.

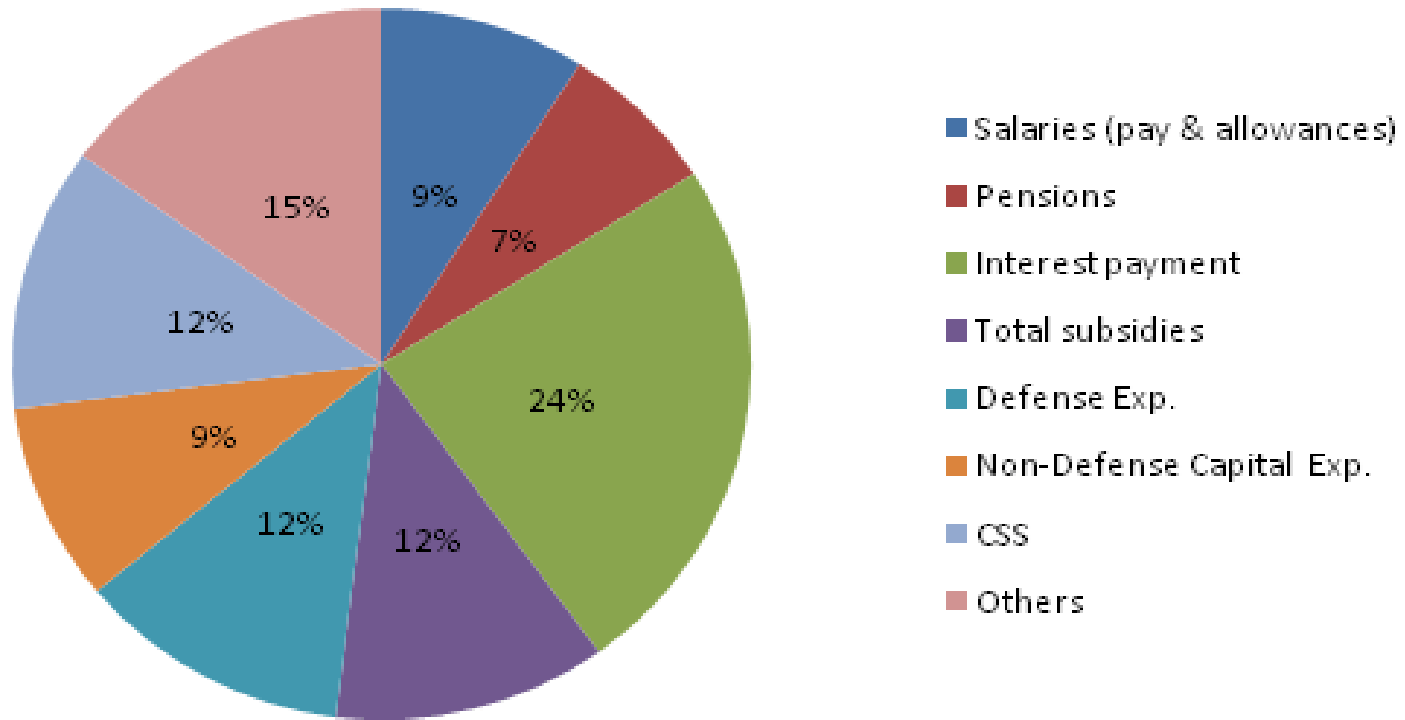
Governments impose both direct and indirect taxes to ensure equity, generally a progressive system of taxation is followed. under this system, taxes are levied on the principle of ability to pay.

Public Expenditure

Public expenditure is spending made by the government of a country on collective needs and wants such as pension, provision, infrastructure.

Public expenditure means the expenditure on the developmental and non-developmental activity such as construction **of roadways and dams** and other activity.

Composition of Public Expenditure in India



Public debt

The public debt is how much a **country owes to lenders outside** of itself

These can include individuals, businesses, and even other governments.

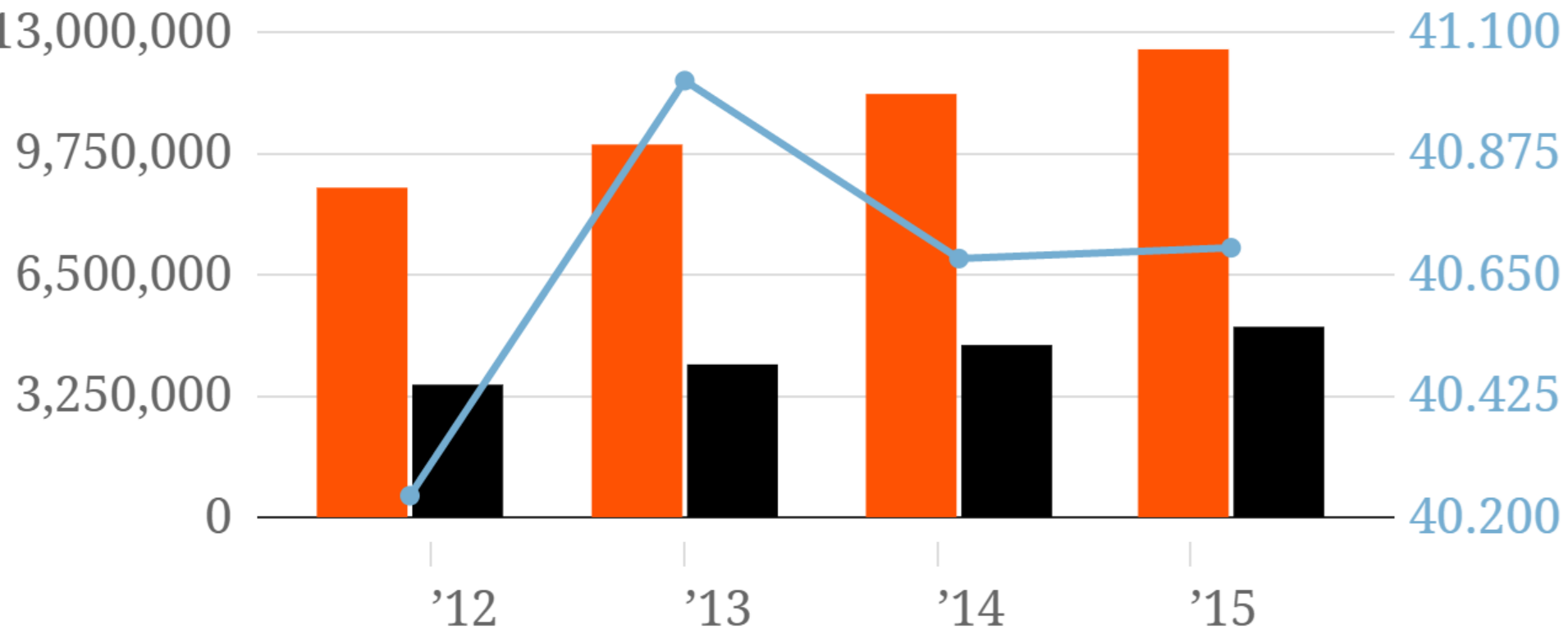
The term "public debt" is often used interchangeably with the term sovereign debt

Apart from a source of revenue to the government ,it is also useful to the government to control inflation.

The government borrows from **both internal and external sources**.the funds thus should be mobilised should be used for productive purposes like development of infrastructure, industrial sector,agriculture then such public debt becomes self financing

India's public debt and GDP (in Rs crore)

■ GDP ■ Public debt ■ % of GDP



Deficit financing

Deficit financing is a method of meeting government deficits through the **creation of new money.**

The deficit is the gap caused by the excess of government expenditure over its receipts

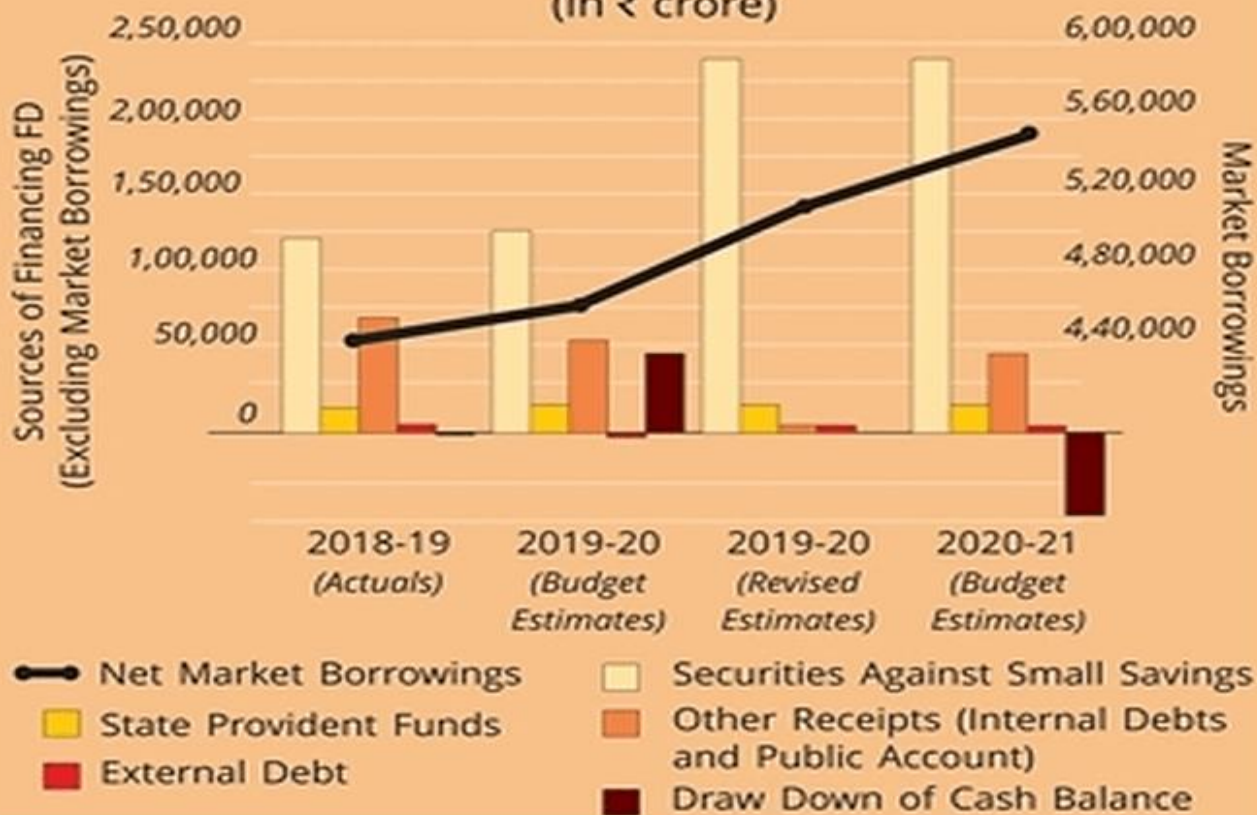
The expenditure includes disbursement on revenue as well as capital account

The receipts similarly comprise revenues on current account as well as capital account


Creation of new money to meet the deficit in use for a long time.

SOURCES OF DEFICIT FINANCING

(in ₹ crore)



Fiscal policy during inflation and deflation



During **Inflation**: Aims at controlling excessive aggregate spending.

During **Depression**: aims at making up deficiency in effective demand; and avoiding unemployment.

Contra cyclical fiscal policy and discretionary fiscal policy

Public finance is interpreted in two ways namely 'sound finance and functional finance' .

Classical economists considered public finance as sound finance.

According to them public finance's main function was to **mobilise resources and enable the government** to discharge its functions.

They believed **in a free enterprise system** and suggested that the functions of the government should be restricted to the **minimum like defence, maintaining law and order** . they advocated a balanced budget

GREAT DEPRESSION TIMELINE: CAUSES & EFFECTS



1929

381.17
Black Thursday.
Dow Jones Industrial
Average drops 11%.
OCT 24

260.64
Black Monday.
The Dow falls an
additional 13%.
OCT 28

230.07
Black Tuesday.
Over 16 million shares
sold as the Dow falls
further 12%.
OCT 29



41.22
Franklin Delano
Roosevelt defeats
Herbert Hoover in
landslide victory for
Presidential election

77.90
Unemployment rate **passes 20%.**



1932

169.84
**The Smoot-Hawley
Tariff Act** is signed
into law, raising tariffs.
Other countries
immediately retaliate
by also raising tariffs.

1930



60.26
Unemployment rate
hits worst level of
depression at
nearly 25%.

1933

100.36
FDR declares a "bank
holiday" as over **9,000
banks** have closed.
MAR 5

100.36
FDR inaugurated and
immediately begins
implementing policies that
were part of the "**New Deal.**"
MAR 4



120.85
After a couple years of
economic growth, the
economy **hits another
recession.**

179.90
Roosevelt
re-elected in even
larger landslide.



1936

104.51
More initiatives are
implemented, including
the Social Security Act,
known as the "**Second
New Deal.**"

1935



1937

130.57
The United
States enters
World War II.



1943

152.58
The number of
unemployed
Americans falls
under one million.



1941

- In the modern era, tools of public finance are used by governments to accelerate growth rate ,reduce poverty,unemployment,inequality.
- By adopting a **progressive system of taxation governments** mobilize revenue and at the same time ensure equity.
- Public expenditure of all economies-developed or developing - has been increasing rapidly due to various factors like rise in population, provision of subsidies,development projects,rising defence needs.
- It is used by **government to influence production and consumption**. Public **debt, again is a potent fiscal weapon to absorb excess money supply** in the economy and helps to control **inflation**. All the three tools are used in combination to face evil effects of trade cycles.
- Public finance plays a significant role in the modern times in economic development.

Limitations of fiscal policy

- The objectives of fiscal policy namely full employment and price stability are conflicting in nature.
- If the government aims at full employment it may incur more expenditure leading to inflation.
- Fiscal policy is used during inflation and deflation.
- In the meantime the problem persists and often gets aggravated. Even after the fiscal measures are introduced to correct inflation or deflation, the impact will be felt only after some time as there is a time lag here also.
- Public authorities should be able to assess the situation precisely and take corrective measures
- Economic situations may warrant the government to adopt strict measures and ensure fiscal prudence. However **political pressures**, fear of losing popular **vote banks** etc may not allow the government to adopt strict measures

Striking balance between inflation and growth through monetary and fiscal policies

The year 1991 was a turning point in the economic history of India due to the introduction of liberalisation, privatisation and globalisation.

Reforms introduced in the various sectors helped the economy to accelerate the growth rate. The banking sector reforms initiated in 1991 and 1998 resulted in significant improvements in banking sector.

Many initiatives were taken to remove the conflict between monetary and fiscal policy and to ensure a balance between inflation and growth. Some of the notable reforms introduced are.

1. **Monetisation of the government's deficit** through adhoc treasury bills was withdrawn.

2. The Fiscal Responsibility and Budget Management Act 2003 necessitated fiscal discipline on the part of the government which also led to better coordination **between monetary and fiscal policies**.

(3) Greater autonomy to the **central bank and better supervision** and regulation by the RBI as per the Basel norms also helped in better implementation of the monetary policy.

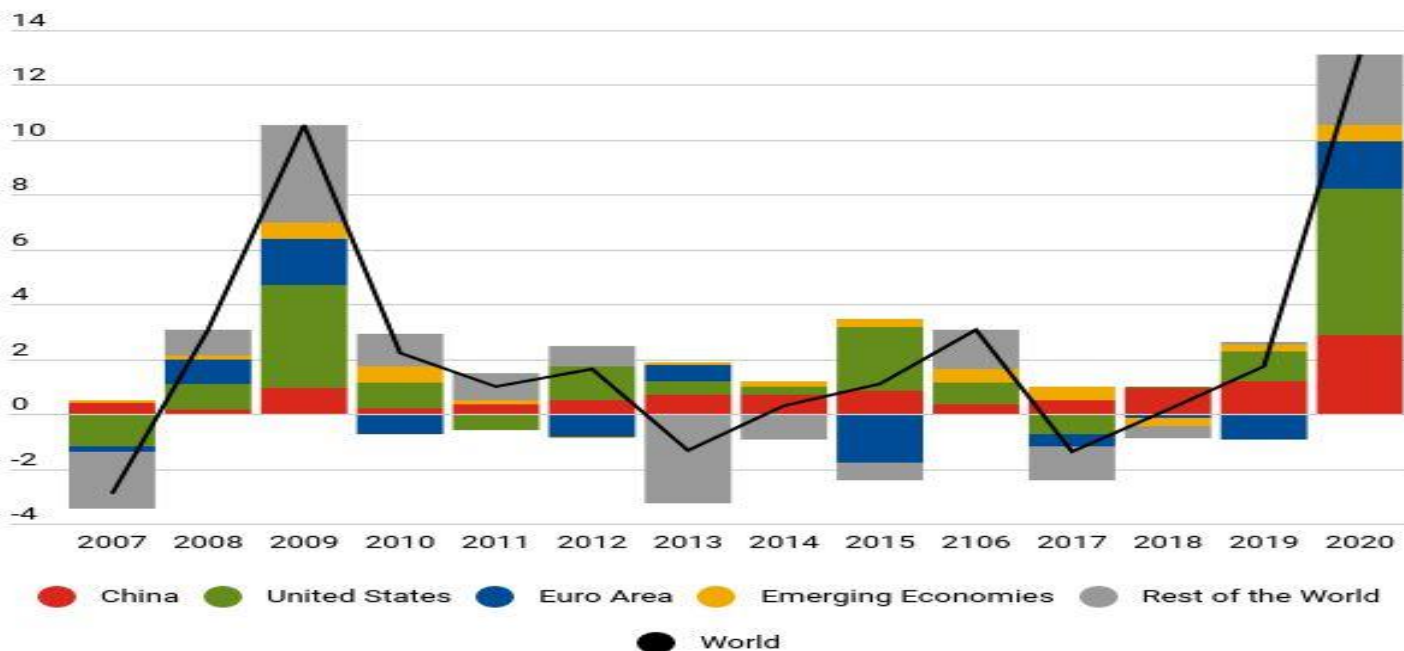
(4) With liberalisation, more capital started flowing towards Indian economy. To prevent inflation **the Market Stabilisation Scheme** was introduced by the RBI in 2004. Under central bank intervenes in the market when inflow of foreign capital increases.

To control the **appreciation of rupee**, which will affect exports, the central bank buys **dollars from the market** by exchanging Indian rupee. This leads to more money supply in the economy. To prevent inflation, **the RBI absorbs this excess money supply** by selling government bonds. Market stabilisation scheme is a classic example of better coordination between monetary and fiscal policies

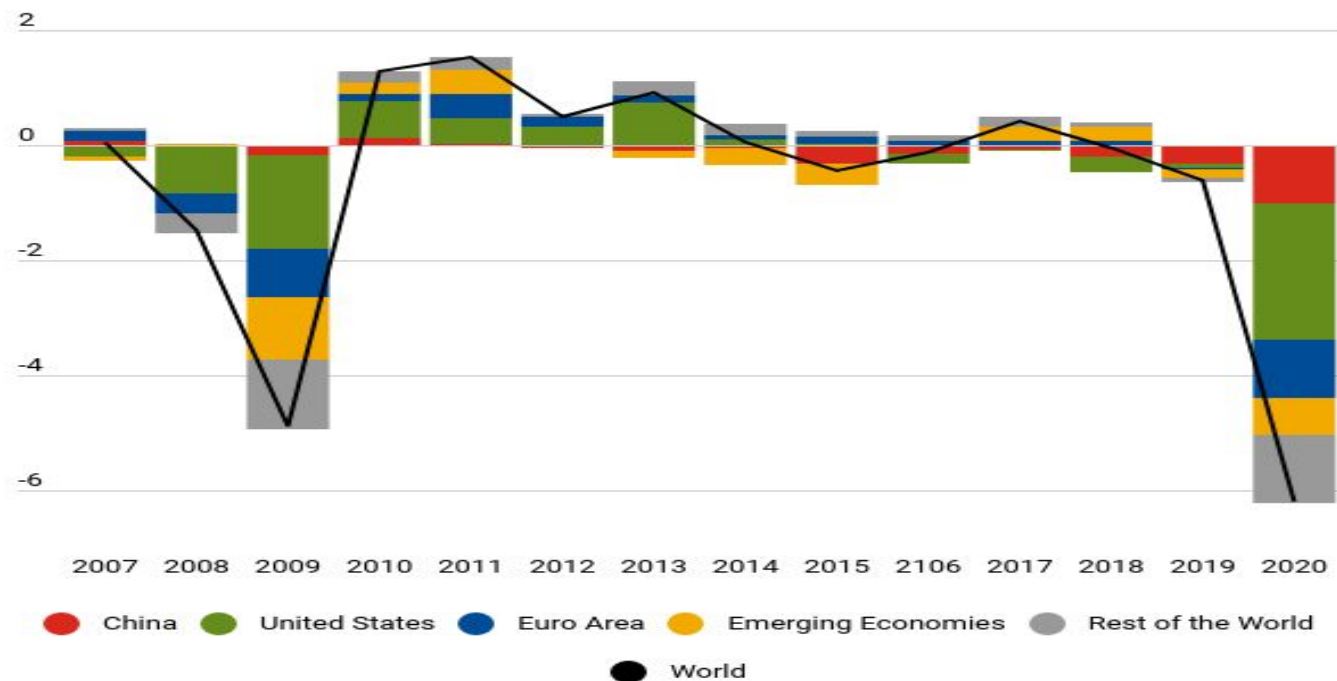
Fast increasing debt and deficits

COVID-19 and its economic impact will increase fiscal deficits and public debt ratios across countries given higher spending and plunging revenues.

(Contribution to the change in global government debt change, 2007-20, % of GDP)



(Contribution to the change in global government fiscal balances change, 2007-20, % of GDP)



Source: IMF, World Economic Outlook database.