FACULTY OF JURIDICAL SCIENCES

Lecture-22

FISCAL POLICY

Fiscal policy refers to the use of government spending and tax policies to influence economic conditions, especially macroeconomic conditions, including aggregate demand for goods and services, employment, inflation, and economic growth.

Fiscal policy is often contrasted with monetary policy, which is enacted by central bankers and not elected government officials.

- Fiscal policy refers to the use of government spending and tax policies to influence economic conditions.
- Fiscal policy is largely based on ideas from John Maynard Keynes, who argued governments could stabilize the business cycle and regulate economic output.
- During a recession, the government may employ expansionary fiscal policy by lowering tax rates to increase aggregate demand and fuel economic growth.
- In the face of mounting inflation and other expansionary symptoms, a government may pursue a contractionary fiscal policy.

Fiscal policy tools are used by governments that influence the economy. These primarily include changes to levels of taxation and government spending. To stimulate growth, taxes are lowered and spending is increased, often involving borrowing through issuing government debt. To put the dampers on an overheating economy, the opposite measures would be taken.
The effects of any fiscal policy are not often the same for everyone. Depending on the political orientations and goals of the policymakers, a tax cut could affect only the middle class, which is typically the largest economic group. In times of economic decline and rising taxation, it is this same group that may have to pay more taxes than the wealthier upper class. Similarly, when a government decides to adjust its spending, its policy may affect only a specific group of people. A decision to build a new bridge, for example, will give work and more income to hundreds of construction workers. A decision to spend money on building a new space shuttle, on the other hand, benefits only a small, specialized pool of experts and firms, which would not do much to increase aggregate employment levels.

Fiscal policy refers to governments spending and taxation. So how much income it has coming in through taxes, and how much it has going out through spending such as welfare, defense, and education.

Fiscal policy is a politicized area as the government has sole control over it. This is in stark contrast to monetary policy which is controlled generally by an independent central bank.

In short, fiscal policy is defined by what governments choose to spend money on and how much they want to bring in from the taxpayer. For instance, the government may come under pressure from the public to invest more in local schools. It may have to borrow the money or increase taxes. A balancing act for fiscal policymakers.

Objectives of Fiscal Policy

Governments have several objectives in mind when deciding on fiscal policy. The six main objectives of fiscal policy are:-

1. Full Employment

One of the government's main objectives is to keep and get people into work. Not only do governments benefit from higher taxes, but also from lower expenditures on social security. An expansionary policy may look to invest in infrastructure which would directly create employment. Alternatively, it may reduce taxes to give consumers more money to indirectly stimulate employment from their purchases.

2. Economic Growth

As an economy grows, its citizens, on the whole, become more prosperous. So this is an important objective. At the same time, governments must be careful. An aggressive expansionary fiscal policy could prove detrimental in the long-term. We only need to look at Greece as an example.
Whilst economic growth is an understandable aim, it must also be considered alongside stability. For instance, heavy government spending can contribute to inflation. Too much spending and it can create high levels of debt and an inflation rate that destroys the nation's wealth.

3. Control Debt

Running a budget deficit is not necessarily bad. However, over time it creates more and more debt. If economic growth and tax receipts do not increase it line, a nation faces an unsustainable level of debt. A rational fiscal policy would aim to control this before having to take drastic action.

4. Control Inflation

When an economy is growing strongly, it may experience high levels of inflation (this may also depend on monetary policy). As 2 percent is generally the target, anything above this is a cause

for concern: particularly if it is consistently above. Even though inflation is a monetary phenomenon, there are steps governments take to try and stem such. With that said, there is little fiscal policy can do if the money supply has been let loose. Nevertheless, governments try by increasing taxes to reduce disposable incomes and hence consumption.

5. Re-distribution

Another aim of the government is to transfer wealth from the rich to the poor. Higher taxes on the rich can sometimes result in high tax receipts, but this is not always the case. Evasion and avoidance may occur, or they may in fact just leave the country. Although small incremental increases may not have such a significant impact in the short-term.

6. Political

Fiscal policy has inevitably become a political tool that many incumbent governments use in a bit to get re-elected. A loosening of fiscal policy and greater spending can often win some 'floating voters' over.