FACULTY OF JURIDICAL SCIENCES

Lecture-23

INSTRUMENTS OF FISCAL POLICY

Major instruments of fiscal policy are as follows:

A. Budget
B. Taxation
C. Public Expenditure
D. Public Works
E. Public Debt

A. Budget:-

The budget of a nation is a useful instrument to assess the fluctuations in an economy.

Different budgetary principles have been formulated by the economists, prominently known as:

(1) Annual budget,

(2) Cyclical balanced budget and

(3) Fully managed compensatory budget.

1. Annual Balanced Budget:

The classical economists propounded the principle of annually balanced budget. They defended it with force till the deep rooted crisis of 1930’s.

The reasons for their reacceptance of this principle are as under:

(i) They maintained that there should be balance in income and expenditure of the government;

(ii) They felt that automatic system is capable to correct the evils;

(iii) Balanced budget will not lead to depression or boom in the economy;

(iv) It is politically desirable as it checks extravagant spending of the state;

(v) This type of budget assures full employment without inflation;

(vi) The principle is based on the notion that government should increase the taxes to get more money and reduce expenditure to make the budget balanced.

However, this principle is subject to certain objections.

These objections are as under:

(i) Classical version that balanced budget is neutral is not well based. In practice, a balanced budget can be expansionary.

(ii)The assumptions of full employment and automatic adjustment are too untenable in a modern economy.

(iii)Some economists also argue that annually balanced budget involves lesser burden of the taxes.

2. Cyclically Balanced Budget:

The cyclical balanced budget is termed as the ‘Swedish budget’. Such a budget implies budgetary surpluses in prosperous period and employing the surplus revenue receipts for the retirement of public debt. During the period of recession, deficit budgets are prepared in such a manner that the budget surpluses during the earlier period of inflation are balanced with deficits.

The excess of public expenditure over revenues are financed through public borrowings. The cyclically balanced budget can stabilize the level of business activity. During inflation and prosperity, excessive spending activities are curbed with budgetary surpluses while budgetary deficits during recession with raising extra purchasing power.

This policy is favored on the following account:

(i) The government can easily adjust its finances according to the needs;

(ii)This policy works smoothly in all times like depression, inflation, boom and recession;

(iii) Cyclically balanced budget simply ensures stability but gives no guarantee that the system will get stabilized at the level of full employment.

3. Fully Managed Compensatory Budget:

This policy implies a deliberate adjustment in taxes, expenditures, revenues and public borrowings with the motto of achieving full employment without inflation. It assigns only a secondary role to the budgetary balance. It lays down the emphasis on maintenance of full employment and stability in the price level. With this principle, the growth of public debt and the problem of interest payment can be easily avoided. Thus, the principle is also called 'functional finance.'

The fully managed compensatory budget has been criticized on the following grounds:

(i) It considers that the government should give blanket guarantee against unemployment.

(ii) This policy is not automatic.

(iii) It brings political upheavals as it delays the implementation of appropriate fiscal measures.

(iv) A country is burdened with debt in the long run period.

(v) This policy is a prolonged lag which in practice has a disturbing effect on the economy.

B.Taxation:-

Taxation is a powerful instrument of fiscal policy in the hands of public authorities which greatly affect the changes in disposable income, consumption and investment. An anti- depression tax policy increases disposable income of the individual, promotes consumption and investment. Obviously, there will be more funds with the people for consumption and investment purposes at the time of tax reduction.

This will ultimately result in the increase in spending activities i.e. it will tend to increase effective demand and reduce the deflationary gap. In this regard, sometimes, it is suggested to reduce the rates of commodity taxes like excise duties, sales tax and import duty. As a result of these tax concessions, consumption is promoted. Economists like Hansen and Musgrave, with their eye on raising private investment, have emphasized upon the reduction in corporate and personal income taxation to overcome contractionary tendencies in the economy.

Now, a vital question arises about the extent to which unemployment is reduced or mitigated if a tax reduction stimulates consumption and investment expenditure. In such a case, reduction of unemployment is very small. If such a policy of tax reduction is repeated, then consumers and investors both are likely to postpone their spending in anticipation of a further fall in taxes. Furthermore, it will create other complications in the government budget.

Anti-Inflationary Tax Policy:

An anti-inflationary tax policy, on the contrary, must be directed to plug the inflationary gap. During inflation, fiscal authorities should not retain the existing tax structure but also evolve such measures (new taxes) to wipe off the excessive purchasing power and consumer demand. To this end, expenditure tax and excise duty can be raised.

The burden of taxation may be raised to the extent which may not retard new investment. A steeply progressive personal income tax and tax on windfall gains is highly effective to curb the abnormal inflationary pressures. Export should be restricted and imports of essential commodities should be liberated.

The increased inflow of supplies from origin countries will have a moderate impact upon general prices. The tax structure should be such which may impose heavy burden on higher income group and vice versa. Therefore, proper care must be taken that the government policies should not bring violent fluctuations and impede economic growth. To sum up, despite certain short-comings of taxation, its significance as an effective anti-cyclical and growth inducing investment cannot be forfeited.

C.Public Expenditure:-

The active participation of the government in economic activity has brought public spending to the front line among the fiscal tools. The appropriate variation in public expenditure can have more direct effect upon the level of economic activity than even taxes. The increased public spending will have a multiple effect upon income, output and employment exactly in the same way as increased investment has its effect on them. Similarly, a reduction in public spending can reduce the level of economic activity through the reverse operation of the government expenditure multiplier.

Public Expenditure in Inflation:

During the period of inflation, the basic reason of inflationary pressures is the excessive aggregate spending. Both private consumption and investment spending are abnormally high. In these circumstances, public spending policy must aim at reducing the government spending. In other words, some schemes should be abandoned and others be postponed. It should be carefully noted that government spending which is of productive nature, should not be shelved, since that may aggravate the inflationary dangers further.

However, reduction in unproductive channels may prove helpful to curb inflationary pressures in the economy. But such a decision is really difficult from economic and political point of view. It is true, yet the fiscal authority can vary its expenditure to overcome inflationary pressures to some extent.

<u>Public Expenditure in Depression:</u>

In depression, public spending emerges with greater significance. It is helpful to lift the economy out of the morass of stagnation. In this period, deficiency of demand is the result of sluggish private consumption and investment expenditure. Therefore, it can be met through the additional doses of public expenditure equivalent to the deflationary gap. The multiplier and acceleration effect of public spending will neutralize the depressing effect of lower private spending’s and stimulate the path of recovery.