**Fiscal Policy: Meaning, Objectives and Role**

**Meaning of Fiscal 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.

**i. 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 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**

**ii. Full Employment**

**iii. Price Stability**

**iv. Equity and Justice**

**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.

**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.

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 must 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.

**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.

Thus, 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.

**Now we are able to summarize the fiscal policy objectives:**

(i) To accelerate the rate of economic growth by stepping up the rate of investment and capital formation

(ii) To increase savings and discourage luxury consumption

(iii) To allocate existing resources to desired and priority sectors so that a rapid economic growth can be achieved

(iv) To reduce inequalities in income and wealth

(v) To maintain reasonable price stability

**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 (ups and down) 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.

**Major Instruments/Components of Fiscal Policy**

Some of the major instruments of fiscal policy are as follows:

1. **Budget**
2. **Taxation**
3. **Public Expenditure**
4. **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.**

Let us briefly explain them:

**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.

**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.

**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.’

**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 shortcomings 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.

**(i) 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.

**(ii) Public Expenditure in Depression:**

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.

**D. Public Debt:**

Public debt is a sound fiscal weapon to fight against inflation and deflation. It brings about economic stability and full employment in an economy. The government borrowing may assume any of the following forms mentioned as under:

**(a) Borrowing from Non-Bank Public:**

When the government borrows from non-bank public through sale of bonds, money may flow either out of consumption or saving or private investment or hoarding. As a result, the effect of debt operations on national income will vary from situation to situation. If the bond selling schemes of the government are attractive, the people induce to curtail their consumption, the borrowings are likely to be non-inflationary.

When the money for the purchase of bonds flows from already existing savings, the borrowing may again be non-inflationary. Has the government not been borrowing, these funds would have been used for private investment, with the result that the debt operations by the government will simply bring about a diversion of funds from one channel of spending to another with the similar quantitative effects on national income?

If the government bonds are purchased by non-bank individuals and institutions by drawing upon their hoarded money, there will be net addition to the circular flow of spending. Consequently, the inflationary pressures are likely to be created. But funds from this source are not commonly available in larger quantity. Its main implication is that borrowings from non-bank public is more advantageous in an inflationary period and undesirable in a depression phase. In short, the borrowing from non-bank public is not of much significant magnitude whether it comes out of consumption, saving, private investment or hoarding.

**(b) Borrowing from Banking System:**

The government may also borrow from the banking institutions. During the period of depression, such borrowings are highly effective. In this period, banks have excessive cash reserves, and the private business community is not willing to borrow from banks since they consider it unprofitable.

When unused cash lying with banks is lent out to government, it causes a net addition to the circular flow and tend to raise national income and employment. Therefore, borrowing from banking institution have desirable and favorable effect specially in the period of depression when the borrowed money is spending on public works programmes.

On the contrary, borrowing from this source dry up almost completely in times of brisk business activities i.e., boom. Actually, demand is very high during inflation period since profit expectation is high in business. The banks, being already loaded up and having no excess cash reserves. Find it difficult to lend to the government. If it is done, it is only through reducing their loans somewhere else.

This leads to a fall in private investment. As the government spending is offset by a reduction in private investment, there will be no net effect upon national income and employment. In nutshell, borrowing from banking institutions have desirable effect only in depression and is undesirable or with a neutral effect during inflation period.

Deficit financing has a desirable effect during depression as it helps to raise the level of income and employment but objection is often raised against its use at the time of inflation or boom. Here, it must be added that through this device, the government not only gets additional resources at minimum cost but can also create appropriate monetary effects like low interest rates and easy money supply and consequently economic system is likely to register a quick revival.

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.