[Academic Script]

[Issues in Fiscal Policy]

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The word fiscal comes from the French word “fisc” which means ‘treasure of government’.

According to Culbarston, “by fiscal policy we refer to government actions affecting its receipts and expenditures which we ordinarily take as measured by the governments receipts its surplus or deficit”.

According Otto Eckstein, “fiscal policy is changes in taxes and expenditures which aim at short –run goals of full employment and price-level stability”.

Fiscal policy is based on the theories of British economist John Maynard Keynes, that explains increasing and decreasing revenue and expenditures i.e., taxes and spending levels influence inflation, employment and the flow of money through the economic system.

Fiscal policy is having prime importance in India. If fiscal and monetary policies are synchronized then overall macroeconomic goals become easier to achieve.

Components of fiscal policy:

There are four main components of fiscal policies:

- Taxation policy
- Expenditure policy
- Investment and disinvestment policy
- Debt and surplus management

Taxation policy:

Direct and indirect tax constitutes the revenue for the government. Through the fiscal policy, government aims to keep the taxes as much progressive as possible. It is very important for the government to take decisions judiciously regarding taxation because of the two reasons-

- Higher than usual tax rate will reduce the purchasing power of people and will lead to a decline in investment and production.
- Lower than usual tax rates would leave more money with people to spend and this would lead to inflation.

Thus, the government has to maintain the balance and impose correct tax rate for the economy.

Expenditure policy:

This policy deals with revenue and capital expenditure. Expenditure on areas like public works like roads, irrigation canals, health, education, infrastructure, etc which are of utmost importance for the development of an economy.

Debt/surplus management:

There are two possibilities in a budget- deficit and surplus.

If the government earn more than what it spends, it is called surplus. If government spends more than what it earns, it is deficit situation. To fund the deficit, government has to borrow from domestic or foreign sources. Government can borrow internally from banks and public.

On the external front government can borrow from foreign government or international institutions. If borrowings dry up then government can resort to printing of currency known as the practice of deficit financing.

Types of fiscal policy:

Generally government adopts two types of fiscal policies according to situation of the economy.

- Expansionary fiscal policy
- Contractionary fiscal policy

Expansionary fiscal policy:

As the word suggests that expansionary fiscal policy stimulates economic growth, Government can expand the economy by spending more or cutting taxes or both. The motive of expansionary policy is to put more money into the consumers' hands so that the purchasing power can be increased. Increase in aggregate demand not only generates jobs but also increases growth rate.

Contractionary Fiscal Policy:

The goal of contractionary fiscal policy is to slow economic growth and that is why it is rarely used. The reason for adopting this is to rule out inflation. To contract the overheated economy, government resorts to increasing tax rates or curtailing expenditure.

Major limitations of fiscal policy are as follows:

Although fiscal policy gained prominence during world depression of 1930's, yet its practical application has a number of problems or limitations.

In view of such a situation, let us understand fully the problems and limitations which are associated with a fiscal policy.

They are:

1. Policy Lags:

During recent times, there is not much argument about the desirability or otherwise of a discretionary fiscal policy. The burning question in this context is related with the timing of the fiscal measures. Unless the variations in taxes and public expenditure are neatly timed, the desired counter-cyclical effects cannot be realized.

There is generally some interval between the time when a particular action is needed and the time when a fiscal measure has its impact felt. The duration of this interval determines the extent to which a specific fiscal measure can be effective. This time interval comprises of three types of lags-recognition lag, administrative lag and operational lag.

(a) Recognition Lag:

This is the interval between the time when action is needed and when it is recognized that action is needed. This lag may exist when a change in the economy and a report concerning the change do not coincide. Such a lag has duration of 3 months. It can be reduced if the forecasting is satisfactory.

(b) Administrative Lag:

This is the interval between the time when need of an action is recognized and the time when the action is actually taken.

This is perhaps the most difficult lag to deal with. Even when the need of action has been recognized, the sanction from legislature and executive must take some time and that may involve about 1 to 15 months of time.

In order to reduce such a lag and to minimize the legislative and executive red-taps, it is important to keep a shelf of public works in readiness. The recognition and administrative lags together determine the inside lag of the fiscal policy and its length, according to Willes, is 4 to 18 months.

(c) Operational Lag:

The time interval between when action is taken and when it has its impact on income and employment is known as the operational or the outside lag. Albert Ando and E.C. Brown have pointed out that the change in personal income taxes produce significant changes in disposable money income and consumption within a month or two; changes in the corporate tax structure produce changes in corporate spending in about 3 or 4 months. Willes was of the view that the outside lag of fiscal policy has a short duration of 1 to 3 months only. J.G. Ranlett, however, considers that these estimates need modification.

On the basis of U.S. income tax data of 1960's, he emphasized that the valuation in income tax rates affected changes on consumption spending with a lag of about 3 to 9 months. Even this estimate of outside lag of fiscal policy is much lower than that of the monetary policy.

2. Forecasting:

Another most serious limitation of fiscal policy is the practical difficulty of observing the coming events of economic instability. Unless they are correctly observed the amount of revenue to be raised, the amount of expenditure to be incurred or the nature and extent of budget balance to be framed cannot be suitably planned. In fact, success of fiscal measures depends on the accurate predictions of various economic activities. In its absence, it proves to be a little bit erratic.

3. Correct Size and Nature of Fiscal Policy:

The most important necessity on which the success of fiscal policy will depend is the ability of public authority to frame the correct size and nature of fiscal policy on one hand and to foresee the correct timing of its application on the other. It is, however, too much to expect that the government would be able to correctly determine the size, nature of composition and appropriate execution-time of fiscal policy.

4. Fiscal Selectivity:

When monetary policy is general in nature and impersonal in impact, the fiscal policy, in contrast, is selective. The former permits the market mechanism to operate smoothly. The latter, on the contrary, encroaches directly upon the market mechanism and gives rise to an allocation of resources which may be construed as good or bad depending upon one's value judgements. A particular set of fiscal measures may have an excessively harsh impact upon certain sectors, while leaving others almost unaffected.

5. Inadequacy of Fiscal Measures:

In anti-depression fiscal policy, the expansion of public spending and reduction on taxes are always important elements. The question arises naturally, whether a specific variation in public spending or taxes will bear the desired results or not. In case the injections or withdrawals from the circular flow are more or less than what are required, the system will fail to move in the desired direction. This results in exaggeration of instability in the economy.

6. Adverse Effect on Redistribution of Income:

It is felt that fiscal policy measures redistribute income, the actual effect will be uncertain. If income is redistributed in favour of the low-income classes whose marginal propensity to consume is high, the effect will be increase in total demand. But the fiscal action will be contractionary if larger part of the additional income goes to people having higher marginal propensity to save.

7. Self-offsetting Effect:

The compensatory fiscal policies of the government may discourage private investment, since the private entrepreneurs have to face a competition from public enterprises in securing labour, raw materials and finances. Moreover, increased involvement of the government in economic activity at the onset of recession strengthens the pessimistic expectations of the private entrepreneurs. The expansion of public spending may be associated with a curtailment of private spending. Consequently, the fiscal measures may be self-offsetting.

8. Reduction in National Income:

Balanced budget multiplier as a fiscal weapon can be gainfully applied during depression is conditioned by the fact of marginal propensity to spend of the recipients of public expenditure being larger than or, at least, equal to that of the taxpayers. In case it becomes smaller, the fiscal programmes under balanced budget will bring about reduction in the national income.

9. Solution for Unemployment:

The purpose of fiscal policy will be defeated if the policy cannot maintain a rising supply level of work effort. The nominal national income will rise with increase in productive efficiency and increased supply of work effort. But if the tax measures are stringent and too high, they will certainly affect the incentive to work. This is an important limitation of fiscal policy.

10. Adverse effect on Debt Management:

The use of fiscal instruments during unemployment and depression is often associated with the subsequent problem of debt management. Because deficit budgeting is the normal fiscal cure, public debt is made for financing it. And if the process of recovery from depression is long, the creation of budget deficit year after year will create a huge problem of debt repayment and debt management.

11. Adverse Psychological Reaction:

Large deficit programmes financed by borrowings bring about adverse psychological reactions. Rumours of government bankruptcy discourage investors and often flight of capital takes place.

12. Hardships in Underdeveloped countries:

The creation of additional income through compensatory fiscal measures is not easily possible in underdeveloped countries as in advanced economies. This is mainly because a stagnating agricultural sector dominates the largest part of their economy where marginal propensity to consume is so high that most of the additional income is consumed and the marketable surplus is at the least.

13. Administrative Problems in Democratic Countries:

In a democracy fiscal policy measures must be a time-consuming process. Legislative actions, administrative tasks and the executive process are often delayed and the original estimates of revenue earnings and government expenditures often become irrelevant. The operational lag relating to fiscal measures results in a considerable erosion of effect and the gap between expected achievement and the real attainment often becomes vast.

14. Crowding Out:

Increased government spending (G) to increased AD may cause "**Crowding out**" Crowding out occurs when increased government spending results in decreasing the size of the private sector.

For example if the government increase spending it will have to increase taxes or sell bonds and borrow money, both method reduce private consumption or investment. If this occurs AD will not increase or increase only very slowly.

- Also Classical economists argue that the government is more inefficient in spending money than the private sector therefore there will be a decline in economic welfare
- Increased government borrowing can also put upward pressure on interest rates. To borrow more money the interest rate on bonds may have to rise, causing slower growth in the rest of the economy.

Summary:

The Finance Ministry has the challenging task of augmenting the rate of economic growth in the face of odds that give rise to economic instability. The exchange rate regimes along with competing countries' tax rates pressurize the exercise of fiscal policy. The components of fiscal policy are, thus, designed to strengthen the Indian economy.