Fiscal Policy

In economics and political science, **fiscal policy** is the use of government revenue collection (taxation) and expenditure (spending) to influence the economy.[1] The two main instruments of fiscal policy are changes in the level and composition of taxation and government spending in various sectors. These changes can affect the following macroeconomic variables in an economy:

- Aggregate demand and the level of economic activity;
- The distribution of income;
- The pattern of resource allocation within the government sector and relative to the private sector.

Fiscal policy refers to the use of the government budget to influence economic activity.

Stances of fiscal policy

The three main stances of fiscal policy are:

- **Neutral fiscal policy** is usually undertaken when an economy is in equilibrium. Government spending is fully funded by tax revenue and overall the budget outcome has a neutral effect on the level of economic activity.
- **Expansionary fiscal policy** involves government spending exceeding tax revenue, and is usually undertaken during recessions.
- **Contractionary fiscal policy** occurs when government spending is lower than tax revenue, and is usually undertaken to pay down government debt.

However, these definitions can be misleading because, even with no changes in spending or tax laws at all, cyclic fluctuations of the economy cause cyclic fluctuations of tax revenues and of some types of government spending, altering the deficit situation; these are not considered to be policy changes. Therefore, for purposes of the above definitions, "government spending" and "tax revenue" are normally replaced by "cyclically adjusted government spending" and "cyclically adjusted tax revenue". Thus, for example, a government budget that is balanced over the course of the business cycle is considered to represent a neutral fiscal policy stance.

Methods of funding

Governments spend money on a wide variety of things, from the military and police to services like education and healthcare, as well as transfer payments such as welfare benefits. This expenditure can be funded in a number of different ways:

- Taxation
- Seigniorage, the benefit from printing money
- Borrowing money from the population or from abroad
- Consumption of fiscal reserves

- Sale of fixed assets (e.g., land)

Borrowing

A fiscal deficit is often funded by issuing bonds, like treasury bills or consols and gilt-edged securities. These pay interest, either for a fixed period or indefinitely. If the interest and capital requirements are too large, a nation may default on its debts, usually to foreign creditors. Public debt or borrowing refers to the government borrowing from the public.

Consuming prior surpluses

A fiscal surplus is often saved for future use, and may be invested in either local currency or any financial instrument that may be traded later once resources are needed; notice, additional debt is not needed. For this to happen, the marginal propensity to save needs to be strictly positive.

Economic effects of fiscal policy

Governments use fiscal policy to influence the level of aggregate demand in the economy, in an effort to achieve economic objectives of price stability, full employment, and economic growth. Keynesian economics suggests that increasing government spending and decreasing tax rates are the best ways to stimulate aggregate demand, and decreasing spending & increasing taxes after the economic boom begins. Keynesians argue this method be used in times of recession or low economic activity as an essential tool for building the framework for strong economic growth and working towards full employment. In theory, the resulting deficits would be paid for by an expanded economy during the boom that would follow; this was the reasoning behind the New Deal.

Governments can use a budget surplus to do two things: to slow the pace of strong economic growth, and to stabilize prices when inflation is too high. Keynesian theory posits that removing spending from the economy will reduce levels of aggregate demand and contract the economy, thus stabilizing prices.

But economists still debate the effectiveness of fiscal stimulus. The argument mostly centers on crowding out: whether government borrowing leads to higher interest rates that may offset the stimulative impact of spending. When the government runs a budget deficit, funds will need to come from public borrowing (the issue of government bonds), overseas borrowing, or monetizing the debt. When governments fund a deficit with the issuing of government bonds, interest rates can increase across the market, because government borrowing creates higher demand for credit in the financial markets. This causes a lower aggregate demand for goods and services, contrary to the objective of a fiscal stimulus. Neoclassical economists generally emphasize crowding out while Keynesians argue that fiscal policy can still be effective especially in a liquidity trap where, they argue, crowding out is minimal. [2]

Some classical and neoclassical economists argue that crowding out completely negates any fiscal stimulus; this is known as the Treasury View, which Keynesian economics rejects. The Treasury View refers to the theoretical positions of classical economists in the British Treasury, who opposed Keynes' call in the 1930s for fiscal stimulus. The same general argument has been repeated by some neoclassical economists up to the present.

In the classical view, the expansionary fiscal policy also decreases net exports, which has a mitigating effect on national output and income. When government borrowing increases interest rates it attracts foreign capital from foreign investors. This is because, all other things being equal, the bonds issued from a country executing expansionary fiscal policy now offer a higher rate of return. In other words, companies wanting to finance projects must compete with their government for capital so they offer higher rates of return. To purchase bonds originating from a certain country, foreign investors must obtain that country's currency. Therefore, when foreign capital flows into the country undergoing fiscal expansion, demand for that country's currency increases. The increased demand causes that country's currency to appreciate. Once the currency appreciates, goods originating from that country now cost more to foreigners than they did before and foreign goods now cost less than they did before. Consequently, exports decrease and imports increase.[3]

Other possible problems with fiscal stimulus include the time lag between the implementation of the policy and detectable effects in the economy, and inflationary effects driven by increased demand. In theory, fiscal stimulus does not cause inflation when it uses resources that would have otherwise been idle. For instance, if a fiscal stimulus employs a worker who otherwise would have been unemployed, there is no inflationary effect; however, if the stimulus employs a worker who otherwise would have had a job, the stimulus is increasing labor demand while labor supply remains fixed, leading to wage inflation and therefore price inflation.

Fiscal straitjacket

The concept of a fiscal straitjacket is a general economic principle that suggests strict constraints on government spending and public sector borrowing, to limit or regulate the budget deficit over a time period. The term probably originated from the definition of straitjacket (anything that severely confines, constricts, or hinders).[4] Various states in the United States have various forms of self-imposed fiscal straitjackets.

References

1. O' Sullivan, Arthur; Steven M. Sheffrin (2003). *Economics: Principles in action*. Upper Saddle River, New Jersey 07458: Pearson Prentice Hall. p. 387. ISBN 0-13-063085-3.
2. "Cliff Notes, Economic Effecs of Fiscal Policy". Retrieved March 20, 2013.
3. Weil, David N. (2008). "Fiscal Policy". In David R. Henderson (ed.). *Concise Encyclopedia of Economics* (2nd ed.). Indianapolis: Library of Economics and Liberty. ISBN 978-0865976658. OCLC 237794267.
4. http://dictionary.reference.com/browse/straitjacket

Bibliography

- Heyne, P. T., Boettke, P. J., Prychitko, D. L. (2002): The Economic Way of Thinking (10th ed). Prentice Hall.
- Larch, M. and J. Nogueira Martins (2009): Fiscal Policy Making in the European Union – An Assessment of Current Practice and Challenges. Routledge.
- Hansen, Bent (2003): The Economic Theory of Fiscal Policy, Volume 3. Routledge.

Source: http://en.wikipedia.org/wiki/Fiscal_policy
April, 2014