Fiscal Policy

Definition of Fiscal Policy. Fiscal policy involves the Government changing the levels of Taxation and Govt. Spending in order to influence Aggregate Demand (AD) and therefore the level of economic activity.

- AD is the total level of planned expenditure in an economy (AD = C+ I + G + X – M)

The purpose of Fiscal Policy:

- Reduce the rate of inflation, (UK government has a target of 2%)
- Stimulate economic growth in a period of a recession.
- Basically, fiscal policy aims to stabilize economic growth, avoiding the boom and bust economic cycle.
- Reduce rate of inflation.
- Improve balance of payments

Fiscal Stance:

- This refers to whether the govt. is increasing AD or decreasing AD

Automatic Fiscal Stabilizers

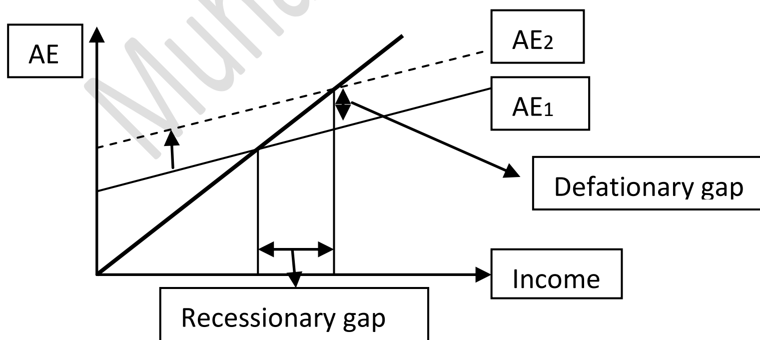
- If the economy is growing, people will automatically pay more taxes (VAT and Income tax) and the Government will spend less on unemployment benefits. The increased T and lower G will act as a check on AD.
- In a recession the opposite will occur with tax revenue falling but increased government spending on benefits, this will help increase AD

Discretionary Fiscal Stabilizers

- This is a deliberate attempt by the govt. to affect AD and stabilize the economy, e.g. in a boom the govt. will increase taxes to reduce inflation
- **Injections (J):** This is an increase of expenditure into the circular flow, it includes govt. spending(G), Exports (X) and Investment (I)
- **Withdrawals (W):** This is leakages from the circular flow this is household income that is not spent on the circular flow. It includes: Net savings (S) + Net Taxes (T) + Net Imports (M)

Expansionary (or loose) Fiscal Policy

- This involves increasing AD,
- Therefore the govt. will increase spending (G) and cut taxes. Lower taxes will increase consumers spending because they have more disposable income(C)
- This will worsen the govt. budget deficit



Government form inflationary fiscal policy at that time when economy faces some recesionary pressure, which results in form of fall in prices, low employment and low rate of economic growth .

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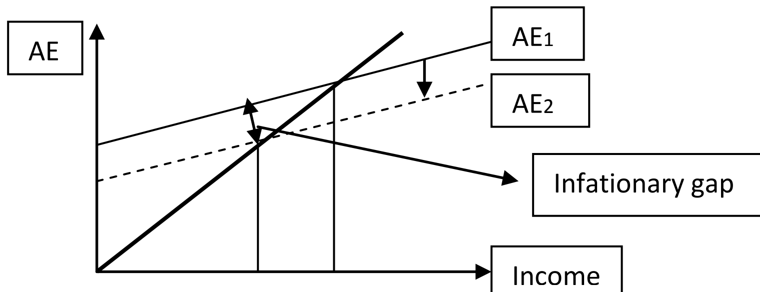
Deflationary (or tight) Fiscal Policy

- This involves decreasing AD
- Therefore the govt. will cut govt. spending (G)
- And or increase taxes. Higher taxes will reduce consumer spending (C).This will lead to an improvement in the government budget deficit



Government form tight fiscal policy at that time when economy faces some inflationary pressure, which results in form of balance of payments problems and rise in general price level.

Fine Tuning: This involves maintaining a steady rate of economic growth through using fiscal policy.

However this has proved quite difficult to achieve precisely.

Evaluation / Criticism of Fiscal Policy

1. **Disincentives of Tax Cuts.** Increasing Taxes to reduce AD may cause disincentives to work, if this occurs there will be a fall in productivity and AS could fall. However higher taxes do not necessarily reduce incentives to work if the income effect dominates.
2. **Side Effects on Public Spending**. Reduced govt. spending to Increase AD could adversely effect public services such as public transport and education causing market failure and social inefficiency.
3. **Poor Information** Fiscal policy will suffer if the govt. has poor information. E.g. If the govt. believes there is going to be a recession, they will increase AD, however if this forecast was wrong and the economy grew too fast, the govt. action would cause inflation.
4. **Time Lags.** If the govt. plans to increase spending this can take a long time to filter into the economy and it may be too late. Spending plans are only set once a year. There is also a delay in implementing any changes to spending patterns.
5. **Budget Deficit** Expansionary fiscal policy (cutting taxes and increasing G) will cause an increase in the budget deficit which has many adverse effects. Higher budget deficit will require higher taxes in the future and may cause crowding out (see below
6. **Other Components of AD**. If the government uses fiscal policy its effectiveness will also depend upon the other components of AD, for example if consumer confidence is very low, reducing taxes may not lead to an increase in consumer spending.
7. **Depends on Multiplier** And change in injections may be increased by the multiplier effect, therefore the size of the multiplier will be significant.
8. **Crowding Out** Increased Govt. 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 govt. 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.

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- Also Classical economists argue that the govt. 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.

9. Monetarist Critique. Monetarists argue that in the LR AS is inelastic therefore an increase in AD will only cause inflation to increase
Note: Fiscal Policy was particularly used in the 50s and 60s to stabilize economic cycles. These policies were broadly referred to as 'Keynesian' In the 1970s and 80s governments tended to prefer monetary policy for influencing the economy.

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Monetary Policy

Monetary policy is the process by which the government, central bank, or monetary authority of a country controls (i) the supply of money, (ii) availability of money, and (iii) cost of money or rate of interest to attain a set of objectives oriented towards the growth and stability of the economy

How to control rate of interest

Rate of interest is controlled by changing ‘Base Rate’. It is the rate at which central bank lends to commercial banks or the rate at which it discounts bills and securities. If base rate is increased, rate of interest will be increased and vice versa.

How to control supply of money

Different methods are used to control supply of money that are:

Open market operation

This method is used to control supply of money in the short run. Central bank sells treasury bills in the open market to banks, other financial institutions or to individuals. As they buy them, liquid assets are fallen and as a result their lending power falls, hence supply of money falls. However, when central bank wants to increase supply of money, it buys back securities, which increases lending power of commercial banks.

Funding

Government issues guilt-edged securities with the indexed interest rate. These are issued even for 25 years. As in case of Treasury bills, their issue also reduces the lending power which reduces supply of money.

Bank reserves ratio

Each bank will have to keep certain ratio of each deposit as a reserve to meet current liabilities. Whenever, central bank wants to reduces supply of money it directs commercial banks to increase their reserve ratio and decrease it to increase supply of money.

Banks’ reserves with the central bank

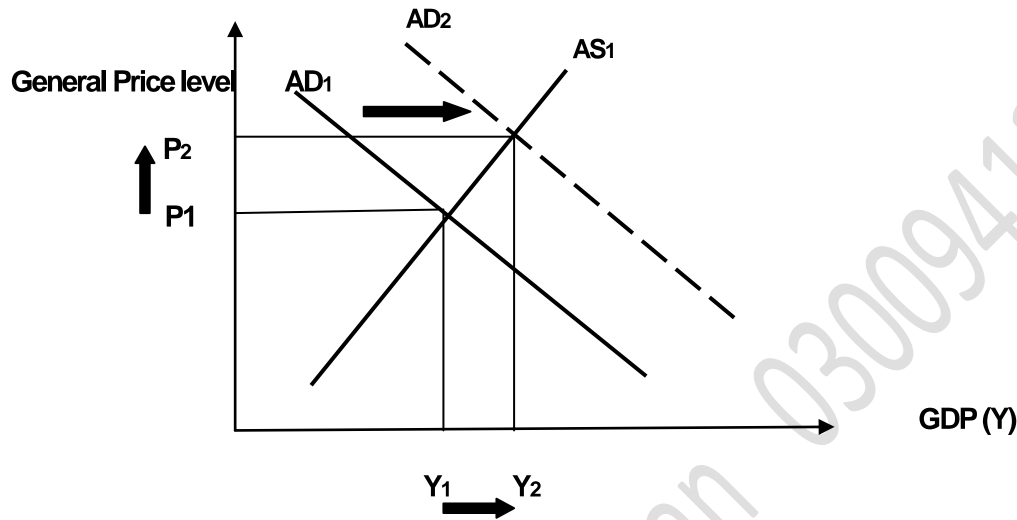
To reduce supply of money, banks’ liquidity should be decreased, therefore, central bank can ask to commercial banks to keep certain amount of reserves with the central bank. As liquidity falls, lending falls and as a result supply of money falls.

Rationing

Sometimes central bank directs commercial banks to lend or do not lend or how much lend for certain objectives. It enables central bank to control supply of money.

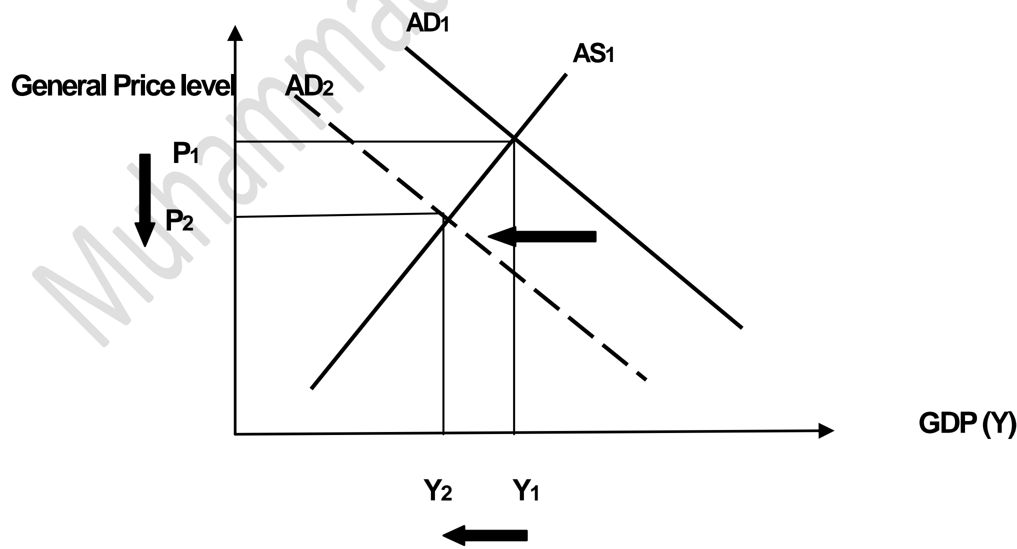
Inflationary monetary policy

This policy is formed when economy faces recessionary pressure. Because of fall in aggregate demand economic activities are reduced, output is fallen as well as fall in the level of employment. According to this policy central bank reduces rate of interest and increases supply of money. As a result AD rises, which leads to increase economic activities, hence, prices, output and employment rise.



Deflationary Monetary Policy

This policy is formed when economy experiences inflationary pressure. Usually under these circumstances economy faces high rate of inflation, and, or may be having deficit balance of payments. Therefore to reduce AD govt. increases rate of interest and reduces supply of money. As AD falls, inflationary pressure is reduced as well as being demand dampening policy, demand for imports falls and balance of payments is improved.



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Limitations of Monetary policy

Controlling the supply of money
To control the supply of money govt. will have to reduce its size of deficit financing, which is, quite unpopular politically. The less successful is the govt. the more will be deficit and more will be borrowing, which increases size of the national debts. As a result not only rate of interest increases but also increase in tax burden for repayments of loan.
Secondly, banks and other financial institution find out to meet the demand as long as people want to borrow. Hence history tells that it is not an effective way to run the monetary policy, this is why economies rely more on the control of rate of interest.

Effectiveness of changing in rate of interest
Although it is more effective then the control of supply of money but it is not also without difficulties.
Firstly, according to economists' estimation it takes on average of 18 months to produce outcomes after changing the rate of interest.
Secondly, increase in rate of interest discourages investment; hence, economy will have to forgo long term growth. As investment falls, there will be a fall in the level of employment. It also increases cost of production, which leads to increase in prices and cost push inflation occurs, as a result cost of living rises.
Thirdly, increase in rate of interest also encourages inflow of hot money, as a result exchange rate rises and exports become less competitive, hence balance of payments' problems occur.
Fourthly it is also political unpopular because people are not willing to pay higher interest rates on overdraft, credit card or mortgage installments.

In **inflationary policy** as rate of interest is reduced, it encourages outflow of hot money which reduces not only the amount of capital but also deters exchange rate. Secondly, if there is recessionary pressure, firms are reluctant to make investment because of pessimistic approach towards expected demand; hence no considerable improvement can be brought.
Accurate monetary control requires accurate prediction of demand curve of money to set the appropriate level of interest rate but because of speculation, demand curve may be unpredictable.

Supply Side Policies

Definition of Supply Side Economics

Supply Side economics is the branch of economics that considers how to improve the productive capacity of the economy. It tends to be associated with Monetarist, free market economics. These economists tend to emphasis the benefits of making markets, such as labour markets more flexible. However, some supply side policies can involve government intervention to overcome market failure

Supply Side Policies are government attempts to increase productivity and shift Aggregate Supply (AS) to the right. A rise in productivity leads to increase in output per worker and hence per capita income rises. It shifts AD rightward which shows an increase in aggregate expenditure.

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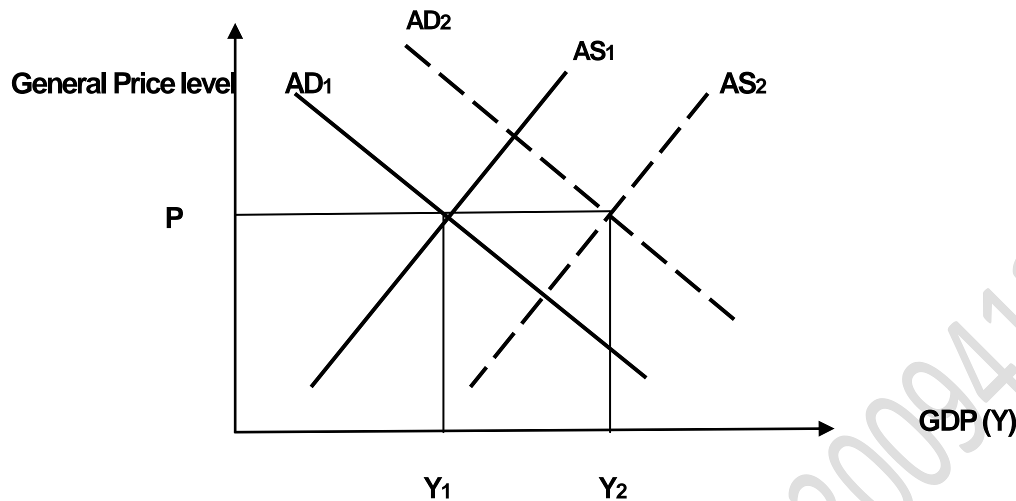
Diagram Showing effect of Supply Side Policies



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Benefits of Supply Side Policies

1. Lower Inflation.
Shifting AS to the right will cause a lower price level. By making the economy more efficient supply side policies will help reduce cost push inflation.

2. Lower Unemployment
Supply side policies can help reduce structural, frictional and real wage unemployment and therefore help reduce the natural rate of unemployment.

3. Improved economic growth
Supply side policies will increase the sustainable rate of economic growth by increasing AS.

4. Improved trade and Balance of Payments.
By making firms more productive and competitive they will be able to export more. This is important in light of the increased competition from S.E. Asia.

Supply Side Policies

Most supply side policies aim to enable the free market to work more efficiently by reducing govt interference.

1. Privatizations.
This involves selling state owned assets to the private sector. It is argued that the private sector is more efficient in running business because they have a profit motive to reduce costs and develop better services.

2. Deregulation
This involves reducing barriers to entry in order to make the market more competitive. For example BT used to be a Monopoly but now telecommunications is quite competitive. Competition tends to lead to lower prices and better quality of goods / service.

3. Reducing Income Taxes.
It is argued that lower taxes (income and corporation) increase the incentives for people to work harder, leading to more output. However this is not necessarily true, lower taxes do not always increase work incentives (e.g. if income effect outweighs substitution effect)

4. Increased education and training
Better education can improve labour productivity and increase AS.
Often there is under-provision of education in a free market, leading to market failure. Therefore the govt. may need to subsidise suitable education and training schemes.
However govt. intervention will cost money, requiring higher taxes, It will take time to have effect and govt. may subsidise the wrong types of training

5. Reducing the power of Trades Unions
This should
a) increase efficiency of firms e.g. less time lost to strikes
b) reduce unemployment (if labour markets are competitive)

6. Reducing State Welfare Benefits
This may encourage unemployed to take jobs.

7. Providing better information about jobs
This may also help reduce frictional unemployment

8. Deregulate financial markets to allow more competition and lower borrowing costs for consumers and firms.

9. Lower Tariff barriers this will increase trade

10. Removing unnecessary red tape and bureaucracy which add to a firms costs

11. Improving Transport and infrastructure.
Due to market failure this is likely to need govt. intervention to improve transport and reduce congestion. This will help reduce firms costs.

12 Deregulate Labour Markets
This is said to be an important objective for the EU to increase competitiveness. E.g. Make it easier to hire and fire workers.

Limitations
Tax cuts may not be successful if workers are contents with their current income and reduction in unemployment benefits does not encourage unemployed if jobs are not available.
Privatization may also not be able to increase efficiencies if firms become private monopolies.
Supply side policies are tend to be for the long run and uncertain in their outcomes and they also require structural changes hence little important for short time objectives.
In all economies resources are limited, for example fertility of land can be increased to the certain extent, similarly, productivity of labours can be increased to the certain limit, and hence, supply side policies are effective to a limit.

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