# Fiscal policy as an economic stabilization measure

FISCAL POLICY AS AN ECONOMIC STABILIZATION MEASURE Fiscal Policy refers to the various decisions undertaken by the government regarding public expenditures and revenue. There are a large number of sub-policies that are encompassed by the fiscal system. But all the policies can be broadly categorized as being either ‘ Public Expenditure’ or ‘ Public Revenue’. It can be said that the fiscal policy is a direct government intervention in the economic processes of an economy. The fiscal policy is very objective in nature, since it creates decisions that can be uniformly applied to the entire economy or to a segment of the economy.

The fiscal policy is considered to be more direct than the monetary policy in its impact on the economy. While the monetary policy’s success depends on the banking / financial system, the fiscal policy operates in an inherent manner in the economy. The fiscal policy’s sub-policies are: ? The Annual Budget of the government – this is a policy statement that directs all economic activities for at least a year. ? Public Debt – this helps the government to raise resources on a quid-pro-quo basis. Deficit Financing – wherein the government can order its Central Bank to release additional money equivalent to the size of the deficit in its budget. ? The Taxation structure – through this fiscal tool the government is able to raise resources on a non-quid-pro-quo basis. ? A wide range of public expenditures – covering productive items (like: irrigation projects, industrial investments, EOC and SOC) and unproductive items (like: welfare measures and general administrative expenses). Depending upon whether the Fiscal Policy increases or decreases the public expenditure in the economy, it is possible to categorize the fiscal policy nto two types: ? An Expansionary Fiscal Policy –

in this case, there is an increase in public expenditure and so there is an improvement in the income generating capacity in the economy. An expansionary fiscal policy causes the multiplier effect to operate leading to an overall macro-expansion. ? A Contractionary Fiscal Policy – in this case, the government’s expenditure falls causing a reduction in the income generating capacity in the economy on account of the operation of the reverse multiplier.

Higher government expenditures will raise aggregate demand both directly via the increase in the government’s demand for goods and services and also indirectly via the expenditure multiplier process. The higher aggregate demand will raise incomes and thereby increase the demand for money. Assuming there is no change in the money supply, there will be excess demand in the money market, which will raise the ROI. However, investment expenditure is negatively related to the ROI. Therefore, the higher ROI will reduce investment expenditure and thereby lead to a reduction in the aggregate demand.

There are two counteracting effects on aggregate demand as a result of a fiscal expansion. The first effect, that of increased government expenditure, is expansionary. The second effect, which is contractionary, is known as the crowding out of private expenditure as a result of the increase in government expenditure. Showing the COE with the help of IS – LM curves: In an economy with unemployed resources there will not be full crowding out because the LM schedule would then not be vertical. A fiscal expansion will raise the ROI, but income will also rise.

Crowding out therefore becomes a matter of degree. The increase in aggregate demand raises income. With the rise in income, the level of saving rises. This expansion in saving, in turn, makes it possible to finance a larger budget deficit without completely displacing private borrowing or investment. In Fig. 1, when an expansionary fiscal policy is in operation, i. e. , public expenditure increases; this leads to an increase in the aggregate demand. On account of this increase, there is an increase of economic activities in the goods market, causing the IS curve to shift upwards from IS1 to IS2.

Thus, at the new equilibrium (E2), the economy experiences a rise in the interest rate from OI1 to OI2 and this happens along with an increase in income from OY1 to OY2. However, it should be noted that the increase in the interest rate has brought about a disincentive for the private sector within the economy. The private investors are dissuaded from borrowing the investible funds lying with the financial system, since the ROI is too high and so unattractive for them. Had the shifting of the IS curve not caused the interest rate to rise (i. e. the ROI was fixed at OI1), then given the new IS situation, the economy would have been at equilibrium at E3 and the income would have risen to OY3. Thus, we see that an expansionary fiscal policy has reduced the possibility of creating income up to OY3 – hence, Y2Y3 represents the amount of additional income lost i. e. , the ‘ Crowding-out Effect’. Showing the COE with the help of AD function: The fiscal policy, with a constant money supply, is less expansionary than it would have been if the money supply were increased to keep the ROIs constant as income expanded.

Hence, the fall in income by Y1Y2 is the crowding out effect. Showing the COE with the help of the PPF: But as soon as an expansionary fiscal policy causes the government spending to increase to g2, the private sector’s spending falls to h2. Therefore, amh2h1 is indicative of the extent of the crowding out effect of the fiscal policy. It is possible to identify two extreme views on the crowding out effect: The Classical case and the Crowding out: In Fig 4A, the increase in government spending causes the shifting of the IS curve from IS0 to IS1.

This causes the ROI to increase from R0 to R1 and the income remains constant at Y0 since the LM curve is vertical. On account of this the investment spending declines from I0 to I1 (as shown in Fig. 4B). Thus as per the Classical interpretation, the fiscal policy has no effect on the national income of the economy – since the LM curve is perfectly inelastic. The Keynesian case and the Crowding out: In Fig 5A, the increase in government spending causes the shifting of the IS curve from IS0 to IS1.

But with a horizontal LM curve, the ROI to remains constant at Rk and the income increases from Y0 to Y1. On account of the reactions in Fig. 5A, the investment demand curve shifts from I0D0 to I1D1. In Fig. 5B. Thus, as per the Keynesian interpretation, the fiscal policy has a significant effect on the national income of the economy – since it causes no dampening of investments by leaving the ROI untouched. Hence, there is no crowding out effect in the extreme position of the Keynesian interpretation. The extent of the crowding out effect depends on two factors: Income elasticity of money demand – When income rises, the extent to which the demand for money increases will determine how much the ROI rises. The higher the income

elasticity of the demand for money, the greater will be the increase in the ROI when the income increases and so the crowding out effect will be high. ? Interest elasticity of investment expenditure – Higher ROIs lead to lower investment expenditure. The more responsive investment expenditures are to the ROIs, the greater will be the fall in investment – i. e. , the larger will be the crowding out effect.

The Policy-Mix: In order to reduce the impact of the crowding out effect caused by the expansionary fiscal policy, the economy should adopt the fiscal policy – monetary policy mix, wherein the crowding out effect is neutralized. This mix can be graphically explained as under: The expansionary Fiscal Policy when it operates by itself creates Y2Y3 level of the Crowding-out Effect due to the upward shifting of the IS curve from IS1 to IS2. This adverse effect on the national income has taken place due to the expansionary Fiscal policy causing the ROI to rise from OI1 to OI2.

The private investors are unwilling to investment at such a high ROI. An appropriate expansionary Monetary Policy can be put into effect to counter the Crowding-out Effect. The ROI can be brought back to the original level of I1from I2, due to the increase in the money supply causing the LM curve to shift downwards from LM1 to LM2. Now, the private investors are ready to invest since the ROI is lower and due to this, the national income ultimately increases from OY1 to OY3. References: Ahuja H. L. Macroeconomics – Theory and Policy Chapter 20S. Chand, Delhi 2002 Begg, Fisher & DornbushEconomics – 5th Edition

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