


**WEEK 10: FISCAL POLICY**

Fiscal policy is based on demand management i.e. raising or lowering the level of aggregate demand. It was seen to have two main roles.

The first was to remove any severe deflationary gaps. In other words, expansionary fiscal policy could be used to prevent a recurrence of the mass unemployment that was experienced between the wars, and deflationary fiscal policy could be used to prevent rampant inflation.

The second role was to smooth out the fluctuations in the economy associated with the business cycle. This would involve reducing government expenditure or raising taxes.

Fiscal policy includes:

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- i. Reduction in government spending. This will directly reduce aggregate demand.
  - ii. The imposition of new taxes or increasing existing ones. This will directly reduce the size of disposable income in the hands of the public and thus curtail private spending. It should be stated here that fiscal policy will be successful only against demand-pull inflation.

Taxes can be classified into:

- |     |                |     |                             |
|-----|----------------|-----|-----------------------------|
| i.  | direct         | ii. | indirect                    |
| i.  | Direct taxes   |     | Income tax, road tax, etc.  |
| ii. | Indirect taxes |     | Taxes on services and goods |

An increase in direct taxes or indirect taxes reduces the individual's disposable income.

### Budget Deficits And Surpluses

An expansionary fiscal policy will involve raising government expenditure and/ or lowering taxes. This will have the effect either increasing the budget deficit or reducing the budget surplus.

A **budget deficit** is where central government's expenditure (both on goods and services and on transfer payments) exceeds its revenue from taxation.

A **budget surplus** is where tax revenue exceeds central government expenditure.

If the government spends more than it receives in taxes, how is it going to finance this deficit? The answer is that it will have to borrow the money. It can do this either by borrowing from the Central Bank, or by selling government security, treasury bills and government bonds. Treasury bills are short-term loans to the government (three months). Bonds are long-term loans (several years). At the end of the loan period, the government redeems the securities at their face value. To persuade people to buy these securities the government has to pay interest or, what amounts to the same thing, sell them below their redemption value.

### DISCRETIONARY FISCAL POLICY

Discretionary fiscal policy is where the government deliberately changes taxes or government expenditure in order to alter the level of aggregate demand. Discretionary changes in taxation or government expenditure, used to alter the level of aggregate demand, are also used for other purposes, including the following:

- Altering aggregate supply. The tax system may be altered so as to provide more incentives (e.g. by cutting the top rates of income tax). This, it is argued, will encourage more investment, more initiative and more risk taking. Government

expenditure may be directed into building up the infrastructure of the economy (e.g. new roads) or into providing grants for research and development or the training of labour.

- Altering the distribution of income. Government transfer payments and taxation are major weapons in redistributing incomes from the rich to the poor.

### **Learning Outcomes:**

Students should be able to:

- Understand the roles of government
- Examine the effectiveness of the government policies

### **Main Reference**

Case, K. E., & Fair, R. C. (2007). *Principles of Economics* (8<sup>th</sup> ed.). Prentice Hall, Chapter 22.

### **Other Reference**

Sloman, J. (1993). *Economics* (3<sup>rd</sup> ed.). Prentice Hall, Chapter 17.

### **Review Questions**

1. What is fiscal policy? How is fiscal policy being administered?
2. What are direct and indirect taxes?