<u>Fiscal Policy</u>

G.E. Public Finance, B. Com (H) 4th Sem

Part-A-Unit – 4- Working of Monetary and Fiscal Policies

Readings: - Case and Fair, Principles of Economics, 10th Edition, Chapter 24 (pp 478-486).

The economy does not always work smoothly. There often occur fluctuations in the level of economic activity. At times the economy finds itself in the grip of recession when levels of national income, output and employment are far below their full potential levels. During recession, there is a lot of idle or unutilized productive capacity, that is, available machines and factories are not working to their full capacity. As a result, unemployment of labour increases along with the existence of excess capital stock. On the other hand, at times the economy is 'over heated' which means inflation (i.e. rising prices) occurs in the economy. Thus, in a free market economy there is a lot of economic instability. The classical economists believed that an automatic mechanism works to restore stability in the economy, recession would cure itself and inflation will be automatically controlled.

However, the empirical evidence during the 1930s when severe depression took place in the western capitalist economies and also the evidence of post second world II period amply shows that no such automatic mechanism works to bring about stability in the economy. That is why Keynes argued for intervention by the government to cure depression and inflation by adopting appropriate tools of macro economic policy.

Macro economic policy refers to the instrument by which a government tries to regulate or modify the economic affairs of the country in keeping with certain objectives. In other words, it "attempts to assess the behaviour of the economy as a whole and to seek ways in which its aggregate performance might be improved". These are achieved through certain tools of macro economic policy. According to Keynes, Monetary policy was ineffective to lift the economy out of depression. He emphasized the role of fiscal policy as an effective tool of stabilizing the economy. However, in view of the modern economists both fiscal and monetary policies play a useful role in stabilizing the economy.

Monetary and Fiscal policies have powerful effects on the economy. The fact that monetary and fiscal policies have the potential to affect the economy suggests that these policies might be used to improve macro- economic performance.

Monetary policy is conducted by the central bank of a country. Fiscal policy is conducted by the Executive and legislative branches of the government and deals with managing a nation’s budget. Monetary and fiscal policies are generally thought of as demand management policies. The purpose of monetary and fiscal policy, taken together is to maintain demand roughly equal to supply in the economy and to maintain the existing price level. The appearance of excess demand will probably cause inflation, while an insufficiency of demand will bring at least temporary unemployment and deflation.

Fiscal policy, the focus of this chapter, refers to the government’s spending and taxing behavior—in other words, its budget policy. (The word fiscal comes from the root fisc, which refers to the “treasury” of a government.) Fiscal policy is generally divided into three categories: (1) policies concerning government purchases of goods and services, (2) policies concerning taxes, and (3) policies concerning transfer payments (such as unemployment compensation, Social Security benefits, welfare payments, and veterans’ benefits) to households.

The Goals of Macroeconomic Policy

• Macroeconomic policy

o Monetary Policy: The Federal Reserve

o Fiscal Policy: The Treasury

o Goals: (1) low unemployment, (2) price stability, (3) economic growth

Economic growth: To potential output, or to increase potential output. Can policy achieve the second? or Fiscal and monetary policy need to coordinate. Different than one (monetary policy) being ruled by the other (fiscal policy)

The Concept of Multiplier:

The theory of multiplier occupies an important place in the modern theory of income and employment. The concept of multiplier was first of all developed by F.A. Kahn in the early 1930s. But Keynes later further refined it. F.A. Kahn developed the concept of multiplier with reference to the increase in employment, direct as well as indirect, as a result of initial increase in investment and employment.

Keynes, however, propounded the concept of multiplier with reference to the increase in total income, direct as well as indirect, as a result of original increase in investment and income. Therefore, whereas Kahn’s multiplier is known as ’employment multiplier’, Keynes’s multiplier is known as investment or income multiplier.

The essence of multiplier is that total increase in income, output or employment is manifold the original increase in investment. For example, if investment equal to Rs.

100 crores is made, then the income will not rise by Rs. 100 crores only but a multiple of it.

Keynesian economics has another important finding. You've learned that Keynesians believe that the level of economic activity is driven, in the short term, by changes in aggregate expenditure (or aggregate demand). Suppose that the macro equilibrium in an economy occurs at the potential GDP, so the economy is operating at full employment. Keynes pointed out that even though the economy *starts* at potential GDP, because aggregate demand tends to bounce around, it is unlikely that the economy will stay at potential.

Extra spending increases incomes and creates jobs, and people then have more to spend. This second round of new expenditure in turn creates more income and jobs – and new spending. Economists call this the multiplier effect. In each round of spending some extra income may be saved, taxed or spent on imports, and this limits the size of the multiplier effect.

The size of the multiplier depends upon household's marginal decisions to spend, called *the marginal propensity to consume* (mpc), or to **save**, called *the marginal propensity to save* (mps). It is important to remember that when income is spent, this spending becomes someone else's income, and so on.

*Every time you get some money either you consume or save. This leads to how much you will spend and how much you will consume discussion. This leads to

MPC=Marginal Propensity to Consume:- It is the portion of additional income that is spent. => ΔConsumption/ ΔIncome (Increase in income is always expected to be associated to be with increase in Consumption)

&

MPS= Marginal Propensity to Save

Spending Multiplier:- 1/mps= 1/1-mpc

Mpc+mps=1

e.g. Suppose governement is spending $1billion & the mpc=0.5

Then mps=1-mpc=1- 0.5=0.5

Multiplier effect= 1/mps= $1billion/0.5= $2 billion

Q. 1 Assume the mpc=0.9 and the government wants total spending to increase by $20 billion.

How much is the multiplier?

How much initial spending must the government do to achieve this goal?

Ans. Mpc=0.9 so mps= 1-0.9= 0.1

Multiplier effect= $20 billion=1/0.1 =>20* 0.1= $2 billion

….The Higher the MPC the higher the Multiplier effect.

Derivation of multiplier:

dY=I+ I.mpc+ I.mpc2+I.mpc3+…….+I.mpcn

= I (1+mpc+…….mpcn)

=I (1/1-mpc)

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