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Introduction

Fiscal policy uses tax policies and government spending to influence macroeconomic conditions, including employment and inflation.

Fiscal Policy refers to government policy in respect of public expenditure, taxation and public debt. It is the means by which the government adjusts its spending levels and tax rates to monitor and influence a nation's economy.

Fiscal policy is based on the principles of Keynesian economics, which basically states that governments can influence macroeconomic productivity levels by increasing or decreasing tax levels and public spending.

What Is Fiscal Policy?

Fiscal policy refers to the use of government spending and tax policies to influence [economic conditions](#), especially [macroeconomic](#) conditions. These include aggregate demand for goods and services, employment, inflation, and economic growth.

During a recession, the government may lower tax rates or increase spending to encourage demand and spur economic activity. Conversely, to combat [inflation](#), it may raise rates or cut spending to cool down the economy.

Fiscal policy is often contrasted with [monetary policy](#), which is enacted by central bankers and not elected government officials.

- Fiscal policy refers to the use of government spending and tax policies to influence economic conditions.
- Fiscal policy is largely based on ideas from British economist John Maynard Keynes.
- Keynes argued that governments could stabilize the business cycle and regulate economic output rather than let markets right themselves alone.
- An expansionary fiscal policy lowers tax rates or increases spending to increase aggregate demand and fuel economic growth.
- A contractionary fiscal policy raises rates or cuts spending to prevent or reduce inflation.

Understanding Fiscal Policy

U.S. fiscal policy is largely based on the ideas of British economist [John Maynard Keynes](#) (1883-1946). He argued that economic recessions are due to a deficiency in the consumer spending and business investment components of aggregate demand.

Keynes believed that governments could stabilize the [business cycle](#) and regulate economic output by adjusting spending and tax policies to make up for the shortfalls of the private sector.¹

His theories were developed in response to the Great Depression, which defied classical economics' assumptions that economic swings were self-correcting. Keynes' ideas were highly influential and led to the [New Deal](#) in the U.S., which involved massive spending on public works projects and social welfare programs.

In [Keynesian economics](#), aggregate demand or spending is what drives the performance and growth of the economy. [Aggregate demand](#) is made up of consumer spending, business investment spending, net government spending, and net exports.

Objectives of Fiscal policy

1. **To promote economic growth:** Government promotes economic growth by setting up basic and heavy industries like steel, chemical, fertilizers, machine tools, etc. It also builds infrastructure like roads, canals, railways, airports, education and health services, water and electricity supply, telecommunications, etc. that foster economic growth. Both basic and heavy industries and infrastructure require huge amount of investment which normally the private sector does not take up. Since these industries and infrastructure facilities are essential for economic growth in the country, the burden to set up and develop them falls on the government.
2. **To reduce income and wealth inequalities:** Government reduces inequalities in income and wealth by taxing the rich more and spending more on the poor. Further, it provides for the employment opportunities to poor that help them to earn.
3. **To provide employment opportunities:** Employment opportunities are increased by the government in various ways, One, jobs are created when it sets up public sector enterprises. Two, it provides subsidies and other incentives like tax holidays, low rates of taxes etc. to private sector that encourage production and employment. It also encourages setting up of small scale, cottage and village industries by people which are employment oriented. This it does by providing them tax concessions, subsidies, grants, loans at low rates of interest, etc. Finally, it creates jobs for poor when it undertakes public works programmes like construction of roads, bridges, canals, buildings, etc.
4. **To ensure stability in prices:** Government ensures stability of prices of essential goods and services by regulating their supplies. Hence, it incurs expenditure on ration and fair price shops that keep sufficient stock of food grains. It also subsidizes cooking gas, electricity, water and essential services like transport and maintains their prices at low level affordable to the common man.
5. **To correct balance of payments deficit:** The balance of payments account of a country records its receipts and payment with foreign countries. When payments to foreigners are more than receipts from foreigners, the balance of payments account is said to be in deficit. Quite often this deficit is caused when a country imports more than it exports. Consequently, the payments

on imports to foreigners are more than the receipts from exports. In such a situation, to reduce the deficit in balance of payment account, the government discourages imports by increasing taxes on them and encourages exports by increasing subsidies and other export incentives. However, it should be noted that tax on import is not a popular measure now as it is treated as an obstacle to free flow of goods and services between countries.