CHAPTER - 12

MACRO STABILIZING POLICIES

FISCAL POLICY:

The word **fiscal** is derived from the word **Fisc** which means treasury therefore fiscal policy deals with the matters of treasury or public finance. Fiscal policy refers to the government policy of public expenditure and taxes. Fiscal policy plays an important role in determining the stability of an economy because it affects the level of income and employment in a country. For example income and employment increases with increase in government expenditure and vice versa.

STANCES OF FISCAL POLICY:

There are two important stances of fiscal policy which are given and explained below.

1. CONTRACTIONARY FISCAL POLICY:

Contractionary fiscal policy refers to the reduction in government aggregate expenditures and raising taxes. During business-cycle expansion, inflationary problems arise in an economy which is corrected with the help of contractionary fiscal policy. In case of contractionary fiscal policy, government expenditures as well as transfer payments are reduced whereas taxes are increased. This reduces the purchasing power of people due to which aggregate demand for goods and services. In this way inflation is controlled.

2. EXPANSIONARY FISCAL POLICY:

Expansionary fiscal policy refers to the increase in government aggregate expenditures and decrease in taxes. In case of business cycle contraction, rate of unemployment increases very rapidly. Therefore in order to tackle the problem of unemployment, expansionary fiscal policy is used in which government expenditures as well as transfer payments are increased whereas taxes are reduced. Due to increase in government expenditures such as construction of dams, roads, railways, parks etc. various job opportunities are created and the problem of unemployment is addressed.

TOOLS OF FISCAL POLICY:

Tools of fiscal policy are generally divided into two i.e. discretionary fiscal policy and automatic stabilizers.

1. DISCRETIONARY FISCAL POLICY:

Discretionary fiscal policy refers to the tools employed with the discretion in order to achieve the desired objectives. Such tools include government expenditures, taxation, transfer payments etc. Among these tools, government expenditures and taxation are important one.

a. **<u>Changes in Government Expenditures:</u>**

Government can change the aggregate demand directly by altering its own purchases of goods and services. For example a government places $30 billion order for the construction of new dam. This order increases the demand for cement which induces the cement manufacturers to hire more workers and increase the production. Due to increase in the demand for cement at each price level the aggregate demand will shift. Now in order to know whether the shift in aggregate demand is higher or lower than the government purchases we must know two important macroeconomic concepts.

❖ **<u>The Multiplier Effect</u>**

Multiplier shows how the economy can amplify the impact of changes in spending therefore it is an important concept of macroeconomics. When the government decides to construct a dam for $30 billion it causes various impacts in the economy. For example cement is widely used in the construction of dam therefore demand for cement will increase. This increase in demand increases the profits of producers and thus they try to produce more for which they need additional workers. In this way purchasing power of both producers and working group rises due to which they increase their own spending on consumer goods. Therefore decision of government to construct a dam raises the demand for the products of many other firms in the economy which means that the decision has a multiplier effect on the aggregate demand.

Formula for Spending Multiplier

The size of multiplier effect that arises when an increase in government purchases induces increase in consumer spending can be achieved with the help of simple formula given below.

Multiplier= 1/(1-MPC)

Here MPC is the marginal propensity to consume which shows the fraction of extra income that a household consumes rather than saves. This formula shows that the size of multiplier is dependent upon the marginal propensity to consume. It means that the size of multiplier increases with the increase in MPC and vice versa.

Suppose that marginal propensity to consume is ¾ and government decides to construct a dam for $30 billion. Now we can easily find the size of multiplier effect for the particular spending of government with help of above formula.

Multiplier= 1/(1-3/4)
Multiplier= 1/(1-0.75)
Multiplier= 1/0.25
Multiplier= 4
Therefore, Size of Multiplier = 4×30 = $120 billion

It means that increase in government spending by $30 billion will increase the aggregate demand by $120 billion.

❖ **<u>The Crowding-Out-Effect:</u>**

When government increases its expenditure in a particular sector, the aggregate demand for goods and services could rise by more or less than the spending of government. It depends on whether the multiplier effect or the crowding-out effect is larger. The multiplier effect suggests that the aggregate demand for goods and services will be higher than the government spending whereas the crowding-out effect indicates that the aggregate demand for goods and services will be lower than the government spending. Crowding-out effect occurs when fiscal expansion raises the interest rates because of excessive demand for money. Due to high interest rates, borrowings become more expensive therefore demand for business investment goods declines. In this way government spending may also crowd out investment.

b. <u>Changes in Taxes:</u>

Other important instrument of fiscal policy is the level of taxation. Government can increase or decrease the tax rates depending upon the prevailing economic conditions. For example if government wants to increase the aggregate demand for goods and services it can do so by reducing personal income taxes. The decrease in income taxes boosts the purchasing power of people due to which they demand more goods and services and the aggregate demand increases. However shift in aggregate demand is also affected by the multiplier and crowding-out effects. When government cut taxes, spending of people increases along with the aggregate demand for goods and services. This is the multiplier effect. On the other hand reduction in taxes increases the income of consumers due to which they demand more money whereas the supply of money is fixed. Therefore interest rates raises due to imbalance between demand and supply of money. Higher interest rates discourage borrowings for investment purposes therefore it is called crowding-out effect.

2. <u>Automatic Stabilizers:</u>

All those tools which operate automatically to stabilize the economy are commonly known as automatic stabilizer. These tools include progressive taxes, unemployment allowances, support prices and stable government expenditures. The explanation of these tools is given below in detail.

❖ **<u>Progressive Taxes:</u>**

Progressive tax is one in which the rate of tax increases with the increase of the size of income e.g. personal income tax, corporate profit tax etc. such type of taxes play a vital role in stabilizing the economy. For example in case of expansion more people enter the tax bracket because tax exemption ceiling is fixed so increase in money income of people make them liable to pay more tax. Collection of more taxes results in the surplus budget which can be used to stabilize the economy. On the other hand in case of contraction, money income of people decreases due to which they pay fewer taxes. The lower amount of tax collection results in deficit budget which can be used to make developmental expenditures therefore it takes the economy out of depression.

❖ **<u>Unemployment Allowances:</u>**

Social security payments and unemployment allowances are important automatic stabilizers. During the phase of expansion there is a tendency towards full employment therefore government expenditures are reduced by cutting down the social security payments. This results in the automatic stabilization of economy. On the other hand, in case of contraction government expenditures are increased by providing more social security payments. This increases the purchasing power of people along with the increase in demand for goods and services. Increase in the aggregate demand boosts the investment in a country and the slump in the economy is eliminated automatically.

- **Stable Government Expenditures**

In case of economic fluctuations, stable government expenditures are very helpful to stabilize the economy automatically. If the economy is in phase of expansion then the government expenditure is lower than the government revenue therefore budget would become surplus. This surplus budget can be used to stabilize the economy. Similarly during the phase of contraction, government expenditures exceed its revenues therefore budget becomes deficit. This deficit budget will automatically stabilize the economy.

- **Support Policy for Farm Prices**

The fluctuation in the prices of agricultural products is higher than prices of all other products. Such fluctuations in the prices of agricultural products has great impact on the overall economy. Therefore stabilizing the prices of agricultural products automatically stabilize the economy. For example in the phase of contraction, the prices of agricultural products are very low due to which government purchases these products at higher prices and build up stock of the products. In this way prices of the agricultural products as well as overall economy is stabilized. On the other hand, in case of contraction the prices of agricultural products are very high due to which government releases the stocks to bring down the prices at the desired level.

Objectives of Fiscal Policy:

Following are some of the important objective of fiscal policy.

1. **Desirable Price Level:**

The main purpose of fiscal policy is to maintain desirable price level in the country. It means that there should be mild change in the general price level for long period of time. If the prices are increasing rapidly then it will affect different sections of society such as fixed income groups, consumers, working classes, farmers etc. On the other hand if prices are falling, then business community suffers due to shrinking of their profits.

2. **Desirable Level of Consumption:**

With the help of fiscal policy government can adjust the consumption habits of the people and can also maintain a certain desirable level of consumption. If government wants to encourage or discourage the consumption of a commodity it can do so by simply changing its market price. The market price of a commodity can be changed by increasing or decreasing the sales tax or excise duty on the commodity.

3. **Desirable Level of Employment:**

Both developed and developing countries try to achieve full level of employment because it reflects a dynamic growth in the economy. This desirable level of employment can be achieved with the help of fiscal policy. For example developed countries can attain the full level of employment by increasing their expenditures under the assumption that the capital expenditure in the private sector remains constant. This will increase the aggregate demand due to which the level of employment will be increased. On the other hand developing countries can increase employment opportunities by increasing its expenditures through construction of new dams, roads, bridges, rail-lines etc.

4. **Desirable Level of Income Distribution:**

Equal distribution of wealth is very important for the socio and economic development of a country. In case of unequal distribution of wealth, the lower class of society suffers more. Government can check the unequal distribution of wealth through progressive taxes in which the rate of tax rises with the rise in size of income. In this way government can increase the rate of direct taxes so that the upper class of society pays more out of their high income. The amount collected from such taxes can be used in various sectors such as education, health care, etc so that the low income groups of society could be benefited.

5. **Economic Growth and Development:**

Achieving a desirable level of economic growth and development is the first priority of all developing countries. Therefore in order to achieve this level of economic growth, a large part of the developmental expenditure is done out of the deficit financing. Government increases the financial resources internally as well as externally to boost the investment opportunities. Similarly it provides various incentives such as tax concessions to the entrepreneurs and Multi-National Companies for this purpose. Government can achieve a high rate of economic growth and development if all these measures are carried out through fiscal policy.

6. **Equilibrium in the Balance of Payments:**

The position of balance of payments of a country has close relation with the overall economic situation of a country. If the value of total imports exceeds the value of total exports there will be disequilibrium in the balance of payments. This disequilibrium in balance of payments can be corrected with the help of fiscal policy. Government can use fiscal policy to promote the exports and reduce the imports. It can do so by increasing the import duties and reducing export duties along with providing various subsidies to the exporters.

Monetary Policy:

There are number of instruments of monetary policy, which are important for business to understand, but, here it is also important to know what Monetary Policy is? Credit performs the important functions. Being the major part of the total supply of money in a modern economy, the value of money is influenced by the volume of credit. The volume of credit in the country is regulated for the economic stability. This regulation of credit by the central bank is known as "Monetary Policy". It is also called Credit Control.

Monetary policy refers to the measure which the central bank of a country takes in controlling the money and credit supply in the country with a view to achieve certain specific economic objectives. It is also being defined as the regulation of cost and availability of money and credit in the economy.

Instruments of Monetary Policy:

The instruments or methods of credit control or instruments of monetary policy are of two kinds:

1. Quantitative Control:

It seeks to control the total quantity of money and bank credit or to make the bank lend more or less. These are four ways of quantitative control.

a. Bank Rate policy:

The bank rate is the rate at which the central bank is willing to discount first class bill of exchange. Bank rate is different from "Market Rate". Market rate is that rate of which the money market is willing to discount bill of exchange. Market rate is influenced by the banks rate. A rise in bank rate is generally followed by a rise in market rate and similarly, a fall or rise in the bank rate is followed by increase and decrease in the borrowing, and the volume of credit will be adjusted accordingly to the requirements of the market.

b. Open Market Operation

Open market operation is the most important instrument of monetary policy. It refers to purchase or sale of government securities, short term as well as long term, at the initiative of central bank, as a deliberate credit policy. These Bonds and securities are purchased or sold from or to the commercial banks and the general public in the country.

c. Change in Reserve Ratio

The commercial banks are required to keep a limited percentage of their deposits by law with the central bank. The central bank charges the ratio according to the need of controlling the credit. If the ration is raised, the cash available with the bank will be reduced, which will compel them to contract the volume of credit. Similarly when the ratio will be lowered, the credit power will expand.

d. Credit Rationing

This instrument of monetary policy is applied only in time of financial crises. The bank can collect by re-discounting bill of exchange, when credit is rationed by fixing the amount. This method of controlling credit can be justified only as a measure to meet exceptional emergencies, because it is open to serious abuses. There can be a danger, the rationing may not be satisfactory and the central bank may abuse the power by giving preferential treatment to favorite customers.

2. Qualitative Control:

It aims to influence the special type of credit, or to divert bank advances into certain channels, or to discourage from lending for certain purpose. These methods managing monitory policy are as below.

a. Consumer Credit Rationing:

The consumer credit method of monetary management can be applied only when there is a rise of the scarcity of certain listed articles in the country. The central bank will impose specific restraints on consumer credit by raising the required down payments and shorting the maximum period of payment.

b. **Moral Persuasion**

The central bank of the country also implies a minor instrument of moral persuasion to influence the total borrowing at the central bank. Moral Persuasion, refer to the appeal to the commercial bank to act according to the directive of the central bank. The central bank may issue directives to commercial banks to follow the policies of the central bank.

c. **Direct Action**

Central bank may take direct action, if his policies are not followed by the commercial banks. Direct action involves direct dealings of central bank with the commercial banks. Direct action may be a refusal on the part of central bank to re-discount the bill of exchange or it may be in the shape of penalty rate of discounting for the banks not following the required policies.

Objectives of Monetary Policy:

The main objectives of monetary policy are here below

1. **Stability of Internal Prices:**

Heavy fluctuation in the general price level is not good for an economy. They result in uncertainty, damaging production and un-employment. To ensure healthy growth of economy, stability in prices is advised through monetary policy

2. **Stability in Exchange Rate:**

Fluctuations in the external value of currency reduce the volume of foreign trade. So the stability in exchange rate is essential, and this objective is achieved by regulating the volume of currency to stabilize the rate of exchange.

3. **Full Employment:**

Another major objective of monetary policy is to achieve full employment of resources. Central bank adopts a suitable policy for this purpose.

4. **Economic Growth:**

In order to raise the living standard of people through higher production and general economic growth, the volume of credit is regulated for the proper supply of credit to the producers