10. Fiscal Policy & Sound & Functional Finance

Q:1 Define Fiscal Policy. Explain its functioning? OR
How can a fiscal Policy influenced on Aggregate Demand?

(A) **Fiscal Policy :-** Fiscal Policy is the Part of government Policy which deal with Public Revenue and Public Expenditure. Fiscal Policy is related with Taxation, Expenditure and Borrowing of the government.

(B) **Meaning :-**

1) **According to Bnehler -** " Fiscal Policy means use of Public Expenditure, Taxes, borrowings and financial Administration to achieve National economic Objectives"

2) **According to Samuelson & Nordhaus -**
" Fiscal Policy is a Process of Shaping Taxation and Public Expenditure for growth of economy which Provide High-Employment and reduce inflation "

Thus Fiscal Policy is related to —

1) Public Revenue 2. Public Expenditure

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(B) Functioning of Fiscal Policy :-

According to Modern economist J.M. Keynes, the main objective of Fiscal Policy is to increase Aggregate demand with the help of → Disposable income, Public and Private investment, Consumption Expenditure, Net Exports and government Purchases.

A High level of Aggregate demand will increase, which bring higher Production, employment, income Standard of Living.

$$AD = C + I + G + (X - M)$$

In Short Run → $C = F(Y_d)$

$$Y_d = Y - \text{Direct Tax} + \text{Transfer Payment}$$

Y_d = Disposable income
Y = Gross income

(C) Fiscal Policy Affect Agg. Demand :-

Various fiscal Policy measures of government affect Agg. Demand as follows :-

1) Consumption (C) can be increased by reducing Taxes (t)
2) Increasing Transfer Payments (TR) will increase Disposable income of People (Y_d)
3) Imposition of Import duties will reduce Import (M) and Subsidies given to Exporters will increase (X) Export

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4) Investment (I) can be increased through Tax Exemption and Subsidies given to Producers

5) Government Expenditure (G) can be increase through government Purchases.

All these decision in Fiscal Policy will increase Aggregate Demand and National out put of Country.

Q:2 What are the Objectives of Fiscal Policy?

(A) Fiscal Policy
(B) Meaning - one definition } Same from Q:1
(C) Objectives of Fiscal Policy :- In developing Countries the goal of Fiscal Policy is to achieve economic growth and development. Some of the main Objectives of Fiscal Policy are ——

1. **Economic Stability** :- In developing and developed economy there is Cyclical Changes in market. This will bring changes in income, out put, employment, investment, Capital Formation in the economy. Here fiscal policy helps Government to control these Fluctuations and bring Stability.

Example - During Depression, Government follows Deficit budget to increase public expenditure and create more income and employment.

During Inflation, Government follows Surplus Budget where government reduce Public Exp. and increase Taxes.

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2) **To reduce Unemployment :-** Government incur Public Expenditure to reduce unemployment and Under-employment. Government start various Public work Programmes to create more employment.

3) **To Reduce Income Inequalities :-** Government Used Taxation and Public Expenditure Policies to reduce income inequalities.
Example :- Progressive direct Taxes impose heavy burden on rich People.
Public Expenditure on social infrastructure, subsidies on Food, housing health and education will help to reduce Income Inequalities.

4) **Full Employment :-** The main aim of Fiscal Policy was to achieve Full employment Level. In developing economies, government expenditure on Social and economic infrastructure is very useful to create more employment opportunities.

5) **Capital Formation :-** Fiscal Policy helped the government to increase the rate of Capital Formation through investment. The government Provide Tax-Exemption and Subsidies to Producers to encourage investments.

6) **To Control Inflation :-** In developing Countries, government adopt Various Programmes of Industrialisation which may result in Inflation. To control Inflation, government adopt a Fiscal Policy which encourage supply of goods and Services to reduce Prices in the market.

7. **Optimum allocation of Resources :-** Main aim of Fiscal Policy is to determine – How the Country's resources will allocated in best Possible way.
Allocation of Resources depend on—
i) Collection of Taxes.
ii) Size government expenditure.
Government can use Taxation and Subsidies for better allocation of resources.

8) **Reduction of Poverty :-** In developing Countries, the Fiscal Policy helps to reduce Poverty through Poverty alleviation Programmes. The Public Expenditure is incurred for many welfare Programmes to reduce Poverty.

9) **Management of Public Enterprises :-** Public Sector enterprises Provide employment opportunities and Provide essential goods and services at low Prices. It also Prevent Private monopolies in the market. Thus, Fiscal Policy helps government to maintain Public sector enterprises.

Q.3 What are the Limitations of Fiscal Policy?

(A) Limitations of Fiscal Policy :-

1. **Underdeveloped Economies :-** Fiscal Policy and Monetary Policy are not useful in Underdeveloped economies. These economies have low taxable capacity,

Large Unorganised sector, non-monetised Financial Sector, low income and Corruption.

2) **Time Gaps :-** Government takes a lot of time to recognise a Problem and then Find Solution. This time gap between a Problem and its Solution will reduce effectiveness of fiscal Policy.

3) **Practical Problems :-** Sometimes Fiscal Policy is not much effective in Present Conditions.

Example :- It is assumed that Surplus Budget can be Used during inFlation. It means government will increase Taxes and reduce Public Expenditure. But it will help to Control InFlation only. It will not increase economic growth and development.

4) **ForeCasting Problem :-** Forecasting is a function OF data Collection and analysis which is difficult in developing Countries. Reliable data about National income, Output, Production, Price level, employment, Consumption and investment etc. is not availble. This will also Create a Problem while Using Fiscal Policy.

5) **Political Pressure :-** Monetary Policy is Under the Control OF Central Bank and Fiscal Policy is Under the Control OF Government. The Democratic governments OFten Put Political Pressure in Fiscal Policy.

6. **Multiplier :-** The effects of Fiscal measures are transferred to the economy through the working of Various multiplier like — Investment multiplier,
— Tax multiplier

But in Practice, it is difficult to measure the Values of multiplier due to various leakages and uncertainities in economy.

Conclusion :- The Success of Fiscal measures depends on the redistribution of income and psychological reactions on the Part of People.

Q:4 What is Sound Finance? what are the Principles of Sound Finance?

(A) SOUND FINANCE :- According to Classical economists, Public Finance has limited scope. They assumed that - " Supply Creates it own Demand and there is no possibility of over Production and Under Production".

Classical economists believed that all the Factors of Production are used by Private Individuals and there is no interference of government in Free working of market. It means classical economists were in Favour of Laissez-Faire Policy or non-intervention Policy of Government.

According to Classical economist, government should follows Balanced Budget.

According to Adam Smith, J. B. Say, David Ricardo and other Classical economist - Sound Finance means the Balanced Budget Approach.

(B) Principles | Features of Sound Finance :-

1. **Balanced Budget :-** The Classical economists were in the favour of Balanced budget where Public Revenue is equal to Public Expenditure (R = E). The Government Put less taxes and spend less Expenditure. Government should have less interference in market activities and it should not borrow as far as possible. Thus Sound finance means Balanced Budget.

2. **Say's Law :-** The Principle of Sound Finance is also based on Say's Law that — **"Supply creates its own demand"**. According to classical economist — as one man's Expenditure is other man's income, it means Aggregate demand is equal to Aggregate supply.

3. **Full Employment :-** As Aggregate Demand = Agg. Supply, AD = AS. It means there is no Possibility of over Production or Under Production. All the Factors of Production are used by Private individuals to earn Profit. These Private Persons will employ all the resources at optimum level. Thus there is Full employment of resources in economy.

4) **Invisible Hand** :- The concept of invisible hand is used by Adam Smith for Private owners of factors of Production. They always working hard to achieve maximum level of effeciency in economy which result in higher Profits. Thus supply of goods will automatically adjusted with demand of People.

5) **Market Efficiency** :- According to Classical economists, Market Failures are only temporary and for short-Period only. Market is fully capable of correcting and adjusting itself. There is no need of any government Regulation and Restrictions on market.

6) **Taxation** :- Classical economists believed that all taxes are harmful and adversely affect the willingness and ability to work, save and invest. So Taxation must be kept at minimum level.

7) **Public Expenditure** :- Sound finance is based on belief that Government which spends Least is the best Government. Government budget was small so the size of Public expenditure was also small. Government has to spend Public Expenditure on traditional areas only.

Example → Defence, Law and order, Justice, Provision of basic and civic amenities.

8] **Deficit Budgets :-** According to David Ricard, Budget Deficits are Uneconomical, harmful and Socially Undesirable. Budget Deficit will not grow the economy because government will increase the taxes to meet deficits.

Conclusion :- Thus, according to the Principles of Sound finance, Government must adopt Balanced Budget. If there is any gap between expenditure and revenue, it will be adjusted with minimum level of borrowing. A Government should spend Less and should not borrow funds as far as possible.

Q:5 Explain Functional Finance. Explain Feature / Principles of functional finance?

(A) Functional Finance :- There was Depression in Europe during 1920 and in United states during 1930. During that Period economists favoured for giving up Sound Finance Principle.

According to modern economist J. M. Keynes → Fiscal measures were the most effective tools to takeout economy from depression.

Fiscal measures like – Taxation, Public Expenditure, Public Debt etc. helps the Government to bring out economy from Depression.

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Example :- During Depression, Government adopt Deficit Policy.
During inflation, Government adopt Surplus Budget

(B) Fundamental Rules of Functional Finance :-

Functional Finance is an economic theory developed by Abba. P. Lerner based on effective demand Principles.
According to Lerner, government should incur Public expenditure to control Business cycles, to achieve Full employment, to increase growth and Development.

Abba. P. Lerner has given Three Fundamental Principles :-

1) The Government should Prepare the budget to achieve Full-employment and Price stability.
2) During inflation, the government should incur Public Expenditure by borrowing money from the Private Sector only which helps to reduce excessive monetary Demand.
3) During inflation, the government should follows Deficit Demand. It means government increase Public expenditure on infrastructure, social security measures during Depression to increase income and employment

(C) Principles / Features of Functional Finance :-

1. **Importance of Fiscal Policy :-** According to A.P. Lerner, Fiscal Policy is important Part of economic Policy.

Fiscal measures like — Taxation, Public Expenditure and Public debt must be adopted according to needs of economy.

Example → During inflation, Surplus budget must be adopted and during Depression, Deficit budget must be adopted.

2) Social Objectives :- According to Functional finance, Public finance has to work for the interest of entire society.

Example :- Every Taxation, Public Expenditure and borrowing Policy bring affects on entire society.

3) Market Failure :- Markets are not always Perfect but they are Fluctuating in nature. In case of market Failure, they donot always correct themselves. It will result in either inflation or Depression.

Example → The Great Depression of 1930 brought US economy down. The Financial Crisis of 2007-08 in USA brought severe and long recession.

In these Situation, Functional Finance, helps the government to take out economy from Crisis.

4) Income Redistribution :- According to modern economists, Equal Distribution of income will increase,

- Average Propensity to Consume,
- the Level of investment
- Full-Employment Level

To achieve Full employment Level, government should redistribute National income in such a way that will –

- increase saving and investment
- increase APC and Aggregate Demand.

5) Aggregate Demand :-

$$AD = C + I + G + (X - M)$$

According to Modern economist J.M. Keynes, Aggregate Demand would determines the Level of national income and Employment. The government should increase Aggregate Demand through Public Expenditure. It will helps government to bringout economy out of Depression.

6) Importance of Fiscal Policy :-

According to A.P. Lerner and J.M. Keynes, Fiscal Policy is most important part of any economic Policy. Fiscal Policy measures like – Taxation, Public Expenditure and Public Debt Policies must be decided by Government as per need of economy.

7) Different Economies Different aims :-

1) In Developed Countries, Government adopt Unbalanced budget To attain Full employment
2) In Developing Countries, Government adopt Planned Process of economic Development.

3) In Less Developed Countries, Government adopt Rabid Economic Growth.

Thus role of Functional Finance is different in different Countries.

(D) **Conclusion :-** Functional Finance Policy is adopted by many advanced Countries. Functional Finance helped Government to achieve high growth and development in developing Countries like India and China.

Q:6 Explain types of Fiscal Policies ?

Types OF Fiscal Policy :- Following are some of the types of Fiscal Policies —

1. **Automatic Stabilisers :-** Many developed economies have built-in Flexibility in their Tax system and Public Expenditure Structure. It will helps government to bring automatic stabilization of the economy during inflation and Recession.

Example :- During Prosperity and inflation, Tax revenue automically increases but Public expenditure on Social Security measures reduces. This will helps to reduce aggregate demand to Control inflation.

During Depression, government increase Public expenditure on Social security measures and Unemployment benefits. This will helps to increase income, output & Agg. Demand during Depression.

2) **Discretionary Fiscal Policy :-** Under this Fiscal Policy, government makes Deliberate changes in Tax Rate, Tax structure, Size of Public Expenditure to achieve Some targets. These changes in Taxation and Public Expenditure brings about desired Changes in Aggregate Demand.

3) **Contra-Cyclical Fiscal Policy | Compensatory Fiscal Policy :-** The main objective of Contra-Cyclical Fiscal Policy is to achieve economic stability. The main aim of this Policy is to minimise the negative effects of business cycles.
This budget used as compensatory fiscal Policy during Recession and inflation.

i) **Fiscal Policy during Recession and Depression :-**
During Recession and Depression, People reduce their Consumption Expenditure and businessman reduce their Investment expenditure. Many resources will remain unutilised which reduce Production of goods and services.
The government has to Formulate Deficit Budget. The Government increases its Public Expenditure and reduce taxes.
When Taxes are reduced then disposable income of People increase which increase consumption Demand.
Government incur huge expenditure on infrastructural Development and Public work Programmes which increase

income, output and employment Opportunities.

ii) **Fiscal Policy During Inflation :-** During inflation, People buy less with their income. Poor People are Suffering more during inflation. Hence, Government adopt surplus Policy to reduce harmful effects of Inflation.

During Inflation Government increas taxes and Public borrowing to reduce monetary Pressure and Aggregate demand of economy.

Thus, Fiscal Policy is Very Useful to achieve economic Stability during recession and inflation.