Chapter 2

Monetary and Fiscal Policies

CHAPTER-2
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2.1 INTRODUCTION

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.

2.2 MONETARY POLICY

According to Harry G. Johnson, “There is probably no field of economics in which the writings of economists are so strongly influenced by both current fashions in opinion and current problems of economic policy as the field of monetary policy.”

Monetary policy embraces all the measures that are undertaken by the monetary authorities to bring about desirable changes in the working of the financial system. Monetary policy plays a crucial role in moulding the economic character of a country because money and credit in a modern economy exercise a vital influence upon the course, nature and volume of economic activities. An appropriately conceived monetary policy can significantly aid economic growth by adjusting the money supply to the needs of growth by directing the flow of funds into the desired channels and by making institutional credit available to the specific fields of economic pursuit. Monetary policy can also help in correcting the economic ills of the economy such as inflation or deflation.

In short, monetary policy is an important economic tool which can be used to attain many macro economic goals.

2.2.1 Meaning and Definition

Monetary policy is the process by which the government, central bank or monetary authority manages the supply of money, or trading in foreign exchange markets. Monetary policy is the exercise of the central bank’s control over conditions governing the quantity of money or money supply. It is an instrument for achieving the objective of general economic policy as set out by the national economic goals i.e. economic growth, full employment and price stability by influencing the level of aggregate demand and there by the level of money income. Monetary policy influences the behavior of expenditures, output, employment and prices.

Because monetary policy is concerned with government attempts to provide a more stable economy by regulating the rate of growth of the money supply, no monetary system can work by itself. In modern economy, credit plays an important part. The expansion and contraction of credit through proper Monetary policy is, therefore, required in the best interest of the economy.

Monetary restraint reduces the availability of credit and increases its cost; and retards the flow of expenditures, employment, income and output. Monetary expansion on the other hand has the opposite effects on credit and thus encourages these flows.

Monetary policy is usually defined as the central bank's policy pertaining to the control of the availability, cost and use of money and credit with the help of monetary measures in order to achieve specific goals.

According to **Harry G. Johnson**, Monetary policy is a "Policy employing the central bank's control of the supply of money as an instrument for achieving the objectives of general economic policy."

A. G. Hart defines monetary policy as a policy "Which influences the public's stock of money substitutes or the public's demand for such assets, or both. That is, policy which influences the public's liquidity position."

From both these definitions, it is clear that a monetary policy is related to the availability and cost of money supply in the economy in order to attain certain broad objectives. The central bank of a nation keeps control on the supply of money toattain the objectives of its monetary policy.

Monetary policy is only a means to an end and not an end in itself. The aims, objects and scope of monetary policy are conditioned both severally and collectively by the economic environment and philosophy of time. Monetary policy has to be structured and operated within the institutional framework of the money market of the country.

Monetary policy can be explained in two different ways:

In a narrow sense, it is concerned with administering and controlling a country's money supply including currency notes and coins, credit money, level of interest rates and managing the exchange rates.

In a broader sense, monetary policy deals with all those monetary and non-monetary measures and decisions that affect the total money supply and its circulation in an economy. It also includes several non-monetary measures like wages and price control, income policy, budgetary operations taken by the government which indirectly influence the monetary situations in an economy.

2.2.2 Objectives of Monetary Policy

Monetary policy, in essence, is the economic policy of the government in the monetary field. Thus, the objective of monetary policy must be regarded as being part of the overall economic objectives to be pursued by the government. Monetary policy should be directed to achieve different objectives, depending on the environment and the time factor.

Monetary policy, being a part of public policy, is obviously designed and directed to achieve different macro economic goals, depending on the basic problems and the nature of economy of the country, from time to time. The primary objective of monetary policy is price stability, which constitutes a pivotal framework condition for economic activity. Price stability ensures that consumers and businesses can make their economic decisions under stable and predictable conditions and thus has a positive impact on economic activity and employment. Monetary policy also has short-term effects on the economy, as key interest rates can be raised in times of economic booms when the economy threatens to overheat and thus endangers price stability. During economic downturns, in contrast, cuts in the key interest rates can help stimulate investment and consumption.

Monetary policy is discernible in developing countries and in India. Much of the early economic theory stressed only on real factors such as savings, investment and technology as main factors of growth.

Objectives of monetary policy have been different in different countries and in different times depending on the nature of problems faced by the monetary authorities of a country.

1. Neutrality of Money

Economists like Wicksteed, Hayek, Robertson feel that the main objective of the monetary policy is the neutrality of money. The policy of neutral money aims at doing away with the disturbing effects of the changes in the quantity of money on important economic variables like income, output, employment and prices. This policy implies that the quantity of money could be so controlled as to have no negative effect on the prices, output and employment. According to this theory money is to remain neutral, i.e., to cause no fluctuations. Economists have always considered money as a passive factor. According to them, money should play only a role of medium of exchange and not more than that. Therefore, the monetary policy should regulate the supply of money. The change in money supply creates monetary disequilibrium. Thus monetary policy has to regulate the supply of money and neutralize the effect of money expansion.

According to this policy, money is only a technical devise having no other role to play. It should be a passive factor having only one function, namely to facilitate exchange. It should not inject any disturbances. It should be neutral in its effects on prices, income, output, and employment. They considered that changes in total money supply are the root cause for all kinds of economic fluctuations and as such if money supply is stabilized and money becomes neutral, the price level will vary inversely with the productive power of the economy. If productivity increases, cost per unit of output declines and prices fall and vice-versa. According to this policy, money supply is not rigidly fixed. It will change whenever there are changes in productivity, population, improvements in technology etc to neutralize fundamental changes in the economy. Under these conditions, increase or decrease in money supply is allowed to result in either fall or raise in general price level. However, this objective of a monetary policy is always criticized on the ground that if money supply is kept constant then it would be difficult to attain price stability.

In a dynamic economy, this policy cannot be continued and it is highly impracticable in the present day economy.

2. Stability of Exchange Rates

The traditional objective of monetary policy has been the achievement of stable exchange rates. This objective was primary, while stability of prices and output was secondary owing to the paramount importance of international trade in the economies of leading countries like England, Denmark, and Japan etc. For this maintenance and proper conduct of the gold standard was considered to be the primary function of the monetary authorities. This way, minor changes in exchange rates were easily noticed. These led to a lot of speculation and consequent dislocation of economies. This imposed on them period of inflation and deflation. This objective is, now considered to be of only secondary importance, except in case of countries like Japan and England, whose prosperity still depends upon foreign trade.

Maintenance of stable exchange rates is an essential condition for the creation of international confidence and promotion of smooth international trade on the largest scale possible. Instability in exchange rates might lead to undesirable effects such as weakening of the value of currency in the world market, speculation and even flight of capital abroad.

Exchange rate is the price of a home currency expressed in terms of any foreign currency. If this exchange rate is very volatile leading to frequent ups and downs in the exchange rate, the international community might lose confidence in our economy. The monetary policy aims at maintaining the relative stability in the exchange rate. The RBI by altering the foreign exchange reserves tries to influence the demand for foreign exchange and tries to maintain the exchange rate stability.

3. Maintaining Price Stability

With the suspension of the gold standard, maintenance of domestic price level has become an important aim of monetary policy all over the world. The bitter experience of 1920's and 1930's has made all most all economies to go for price stability. Both inflation and deflation are dangerous and detrimental to smooth economic growth. They distort and disturb the working of the economic system and create chaos. Both of them are bad as they bring unnecessary loss to some groups where as undue advantage to some others. They have potential power to create economic inequality, political upheavals and social unrest in any economy. In view of this, price stability is considered as one of the main objectives of monetary policy in recent years. It is to be remembered that price stability does not mean that prices of all commodities are kept constant or fixed over a period of time. It refers to the absence of sharp variations or fluctuations in the average price level in the country. A hundred percent price stability is neither possible nor desirable in any economy. It simply implies relative price stability. A policy of price stability checks cyclical fluctuations and smoothen production and distribution, keeps the value of money stable, prevent artificial scarcity or prosperity, makes economic calculations possible, introduces an element of certainty, eliminate socio-economic disturbances, ensure equitable distribution of income and wealth, secure social justice and promote economic welfare. On account of all these benefits, monetary authorities have to take concrete steps to check price oscillations. Price stability is considered as one of the prerequisite condition for economic development and it contributes positively to the attainment of a steady rate of growth in an economy. This is because price stability will build up public morale and instill confidence in the minds of people, boost up business activity, expand various kinds of economic activities and ensure distributive justice in the country. Prof Basu rightly observes, “A monetary policy which can maintain a reasonable degree of price stability and keep employment reasonably full, sets the stage of economic development”.

4. Full Employment

It refers to absence of involuntary unemployment. In simple words 'Full Employment' stands for a situation in which everybody who wants jobs get jobs. However, it does not mean that there is a zero unemployment. In that senses the full employment is never full. Monetary policy can be used for achieving full employment. If the monetary policy is expansionary then credit supply can be encouraged. It could help in creating more jobs in different sector of the economy. Many well-known economists like Crowther, Halm, Gardner Ackley, William, Beveridge and Lord Keynes have strongly advocated this objective in the context of present day situations in most of the countries. Advanced countries normally work at near full employment conditions. Their major problem is to maintain this high level of employment situation through various economic policies. This object has become much more important and crucial in developing countries as there is unemployment and under employment of most of the resources. Deliberate efforts are to be made by the monetary authorities to ensure adequate supply of financial resources to exploit and utilize resources in the best possible manner so as to raise the level of aggregate effective demand in the economy. It should also help to maintain balance between aggregate savings and aggregate investments. This would ensure optimum utilization of all kinds of resources, higher national output, income and higher living standards to the common man.

5. Rapid Economic Growth

This is comparatively a recent objective of monetary policy. Achieving a higher rate of per capita output and income over a long period of time has become one of the supreme goals of monetary policy in recent years. A higher rate of economic growth would ensure full employment condition, higher output, income and better living standards to the people. Consequently, monetary authorities have to take the necessary steps to raise the productive capacity of the economy, increase the level of effective demand for various kinds of goods and services and ensure balance between demand for and supply of goods and services in the economy. Also they should take measures to increase the rate of savings, capital formation, step up the volume of investment, direct credit money into desired directions, regulate interest rate structure, minimize economic and business fluctuations by balancing demand for money and supply of money, ensure price and overall economic stability, better and full utilization of resources, remove imperfections in money and capital markets, maintain exchange rate stability, allow the inflow of foreign capital into the country, maintain the growth of money supply in consistent with the rate of growth of output minimize adversity in balance of payments condition, etc. Depending upon the conditions of the economy money supply has to be changed from time to time. A flexible policy of monetary expansion or contraction has to be adopted to meet a particular situation. Thus, a growth-friendly monetary policy has to be pursued by monetary authorities in order to stimulate economic growth. It is the most important objective of a monetary policy. The monetary policy can influence economic growth by controlling real interest rate and its resultant impact on the investment. If the RBI opts for a cheap or easy credit policy by reducing interest rates, the investment level in the economy can be encouraged. This increased investment can speed up economic growth. Faster economic growth is possible if the monetary policy succeeds in maintaining income and price stability.

6. Greater Equality in Income Distribution

As far as the objective of greater equality in the distribution of income and wealth is concerned, most of the economists argue that fiscal policy is likely to be more successful as compared to the monetary policy. Many economists used to justify the role of the fiscal policy is maintaining economic equality. However, in recent years economists have given the opinion that the monetary policy can help and play a supplementary role in attainting an economic equality. Monetary policy can make special provisions for the neglect supply such as agriculture, small-scale industries, village industries, etc. and provide them with cheaper credit for longer term. This can prove fruitful for these sectors to come up. Thus in recent period, monetary policy can help in reducing economic inequalities among different sections of society.

According to **S.B. Gupta,** the best policy in this respect is a policy of long run price stability at maximum feasible output. This may be referred to as the policy of "long-run price stability at maximum feasible output, other goals of economic policy, fuller employment, a high rate of growth, greater equality, and healthy balance of payments are also promoted to the maximum extent".

7. **Equilibrium in the Balance of Payments**

This objective has assumed greater importance in the context of expanding international trade and globalization. Today most of the countries of the world are experiencing adverse balance of payments on account of various reasons. It is a situation where in the import payments are in excess of export earnings. Most of the countries which have embarked on the road to economic development cannot do away with imports on a large scale. Imports of several items have become indispensable and without these imports their development process will be halted. Hence, monetary authorities have to take appropriate monetary measures like deflation, exchange depreciation, devaluation, exchange control, current account and capital account convertibility, regulate credit facilities and interest rate structures and exchange rates etc. In order to achieve a higher rate of economic growth, balance of payments equilibrium is very much required and as such monetary authorities have to take suitable action in this direction.

2.2.3 Instruments of Monetary Policy

The instruments of monetary policy are of two types: first, quantitative, general or indirect; and second, qualitative, selective or direct. The level of aggregate demand through the supply of money, cost of money and availability of credit.

They are meant to regulate the overall level of credit in the economy through commercial banks. The selective credit controls aim at controlling specific types of credit. They include changing margin requirements and regulation of consumer credit.

A) Quantitative Credit Controls

The first category includes bank rate variations, open market operations and changing reserve requirements.

1. Open Market Operations

Open market operations are the most important monetary policy tools because they are the primary determinants of changes in interest rates and the monetary base, the main source of fluctuations in the money supply. The technique of open market operations as an instrument of monetary policy refers to purchasing or selling of government securities from large banks or government securities dealers. Open market operations refer to the buying and selling of government securities, treasury bills, gold and foreign exchange by a central bank in the open market. Government borrows to finance its deficits. Reserve Bank of India purchases government securities from the public, bank reserves are increased by corresponding amount because government pays for these securities and money flows from government accounts towards public who, in turn, deposit the amount in their respective accounts thereby increasing banks deposits. Banks utilizing their powers of creation of credit increase the credit supply in the economy. This results in more expenditure, output and employment. Thus, open market operations directly affect the monetary base and the purchases of government securities increase the monetary base. Open market purchases expand the monetary base, thereby raising the money supply and lowering short-terms interest rates.

Similarly, Reserve Bank of India sells the governments securities in open market to the public. The cash with public and with banks decreases because they have to pay for these securities by writing cheques. The sell of government securities, thus, decreases the monetary base. Open market sales shrink the monetary base, lowering the money supply and raising short term interest rates.

Thus, the open market operations gives direct control over monetary base and over the past few decades open market operations have been done to prevent unchecked expansion of liquidity through monetization of government debt. Accordingly, sale of government securities exceeds purchases on an annual basis.

2. Reserve Requirements

The instrument of monetary policy has not been actively used in India for quite long period until 1956. This weapon was suggested by Keynes in his 'Treatise on money' and the USA was the first to adopt it as a monetary devices. Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank. When prices are rising, the central bank raises the reserve ratio. Banks are required to keep more with the central bank. Their reserves are reduced and they lend less. The volume of investment, output and employment are adversely affected. In the opposite case, when the reserve ratio in lowered, the reserves of commercial banks are raised. They lend more and the economic activity is favorably affected. Changes in reserve requirements affect the money supply by causing the money supply multiplier to change. A rise in reserve requirements reduces the amount of the deposits that can be supported by a given level of the monetary base and will lead to a contraction of the money supply. Conversely, a decline in reserve requirements leads to an expansion of the money supply because more multiple deposits creation can take place.

In India RBI act, 1934 puts that all scheduled banks were required to maintain a minimum cash reserve of 5 percent of their demand deposits and 2 percent of their time deposits with the Reserve Bank of India. This system continued till 1956 and this instrument of monetary policy was never used for complete two decades. The RBI act was amended in 1956 and it was given the power to change reserve requirements between 5 to 20 percent of demand deposits and 2 to 8 percent of time deposits. The Amendment also empowered RBI to issue instructions to scheduled banks to maintain with it certain percentage of its liabilities in cash over and above the minimum cash reserve requirements (CRR). The RBI used its power for the first time in 1960 and the additional reserve requirements were fixed at 25 percent of the increase in deposits but it did not yield the desired results. Commercial banks satisfied the reserve requirements by making portfolio adjustments. They sold government securities to fulfill the cash reserve ratio requirement. In 1962, RBI act was again amended and statutory liquidity ratio (SLR) was fixed at 15 percent over and above reserve requirement. The act was also empowered RBI to determine statutory liquidity ratio for commercial banks. The SLR was raised up to 38 percent in 1988. During the economic reforms era on the recommendation of Narsimha Committee SLR and CRR have been reduced. The rate of CRR and SLR maintained by scheduled commercial banks on total net demand and time liabilities was fixed at not less than 14.5 percent and 25 percent respectively in 1996.

The technique of reserve requirement (CRR) has been employed quite often in recent years along with the statutory liquidity ratio (SLR). The purpose of the extensive use of cash reserve ratio (CRR) is to control credit creation power of banks in the wake of the expanding liquidity in the banking system due to higher growth of primary deposits. It is observed that the nationalized banks were defaulting in maintaining CRR and the SLR, thus, defeating the very purpose. It is also true that CRR as an instrument of credit control cannot be used beyond a certain point since Reserve Bank has to consider the necessity of meeting the needs of productive credit of key sectors of the economy. Compared to other instruments of monetary policy such as open market operation, reserve requirements are more difficult to change frequently. The CRR does not have quick and selective impact on bank reserves.

A high cash reserve ratio is inevitable at the present time. Before we can substitute the cash reserve ratio by indirect instruments of control, we need to undertake comprehensive institutional development of the government securities market.

3. Discount Rate

It is also called the bank rate policy. Commercial banks and other financial institutions can borrow from the central banks of a country at discount rate. The amount that these banks and institution borrow from central bank affects the monetary base. The important thing about the bank rate or discount rate is that it is lower than bank lending rate, therefore banks have an incentive to borrow from the central bank at discount rate and lend those funds at higher interest rates.

Discount rate policy, which primarily involves changes in the discount rate, affects the money supply by affecting the volume of discount loans and the monetary base. A rise in discount loans adds to the monetary base and expands the money supply, a fall in discount loans reduces the monetary base and shrinks the money supply.

The Reserve Bank of India like all other central banks is empowered to use discount rate as an instrument of credit control. The discount rate may be raised or lowered depending upon the requirement of credit and overall economic conditions prevailing in the country. The effectiveness of his instrument depends upon:

A. The availability of funds with the banks,

B. Availability of such credit instruments which can be presented to central bank for rediscounting and,

C. Dependence of commercial banks for financial assistance on the central bank of a country.

When bank rate is lowered, theoretically speaking, banks have incentive to borrow more and expand credit as they earn more by lending the funds to business firms at market interest rate. Similarly, when it is raised commercial banks borrow less and it lowers their power to expand credit. Increase in discount rate is indication of tight money policy and lowering of discount rate is the indication that government is following easy or cheap money policy. The use of discount rate as a tool of monetary policy has been criticized by many. Iyenger says, in a planned economy which has a large public sector of investment and where government has a battery of powers of direct regulation of investment the efficiency of bank rate changes is less clear than it is in industrially advanced countries with a free economy. But it would be fallacious to argue that changes in bank rate are out of place in Indian conditions.

B) Qualitative Credit Controls

It aims at regulating the volume of credit given for specific purposes. Selective credit controls include the following credit controls measures.

1. Credit Rationing

When there is shortage of institutional credit available for the business sector, the large and financially strong sectors or industries tend to capture the lion's share in the total institutional credit. As a result, the priority sectors and weaker but essential industries are starved of necessary funds, mainly because bank credit goes to the non-priority sectors. In order to curb this tendency, the central bank resorts to credit rationing measures. Generally, three measures are adopted: a)Imposition of upper limits on the credit available to large industries and firms, b.)Charging a higher or progressive interest rate on bank loans beyond a certain limit. c.)Providing credit to weaker sectors at lower internal rates.

2. Change in Lending Margins

The banks advance money more often than not against a mortgage of property-land, building, jewellery, shares, stock of goods etc. The banks provide loans only upto a certain percentage of the value of the mortgaged property. The gap between the value of the mortgaged property and amount advanced is called 'lending margin.' The central bank is empowered to increase or decrease the lending margin with a view to decreasing and increasing the bank credit.

3. Moral Suasion

The moral suasion is a method of persuading and convincing the commercial banks to advance credit in accordance with the directive of the central bank in the economic interest of the country. This method is adopted in addition to quantitative and other selective methods, particularly, when effectiveness of these methods is doubtful. Under this method, the central bank writes letters to and holds meetings with banks on money and credit matters with the objectives of persuading banks to act according to the instructions and advise of the central bank in the interest of the economy as a whole.

4. Direct Controls

Where all other methods prove ineffective, the monetary authorities resort to direct central measures with clear directive to the banks to carry out their lending activity in a specified manner. There are however rare instances of direct control measures.

As a matter of fact it is difficult to say which of the two methods is more useful. Their choice depends on the economic conditions of the country concerned. If the objective of the central bank is to achieve price stability or to remove the evil affects of inflation and deflation, then it should adopt quantitative credit control. On the other hand, if the objectives are: economic development, increase in level of employment, and equal distribution of income, then it should enforce qualitative or selective credit control. Consequently, different industries, sectors and people should be provided credit in accordance with the priorities stated in the plans.

2.3 FISCAL POLICY

The most important instrument of government intervention in the economy today is that of fiscal or budgetary policy. Fiscal policy refers to the taxation, expenditure and borrowing by the government. The economists now hold the government intervention through fiscal policy is essential in the matter of overcoming recession or inflation as well as of promoting and accelerating economic growth.

2.3.1 Meaning and Definitions

The fiscal policy is concerned with the raising of government revenue and incurring of government expenditure. The government frames a policy called budgetary policy or fiscal policy. So, the fiscal policy is concerned with government expenditure and government revenue. Fiscal policy has to decide on the size and pattern of flow of expenditure from the government to the economy and from the economy back to the government.

According to **J.M. Culbertson**, "By fiscal policy we refer to government actions affecting its receipts and expenditures which we ordinarily takes as measured by the government's net receipts, its surplus or deficit." The Government may offset undesirable variations in private consumption and investment by anti-cyclical variations of public expenditures and taxes.

Arthur smithies defines fiscal policy as "a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment." Though the ultimate aim of fiscal policy is the long run stabilisation of the economy, yet it can only be achieved by moderating short run economic fluctuations.

Otto Eckstein defines fiscal policy as "Changes in taxes and expenditures which aim at short run goals of full employment and price -level stability."

During a recession or depression fiscal policy should help in increasing demand. For this purpose, the government can increase its expenditure and spend more on public works. This will provide employment to more people. The government can also increase its expenditure on subsidies to producers of consumer goods so as to increase consumption spending. Similarly, the government can lower its tax rates so as to stimulate consumption and investment. Thus, a budget deficit during a depression helps greatly in removing unemployment. On the other hand, during periods of inflation, there is too much of demand and hence the government should reduce its own expenditure and curb private spending by increasing taxes. Thus, in periods of inflation we should have surplus budgets. Therefore, there is no inherent superiority in a balanced or a surplus budget. It all depends on the prevailing economic situation. This view of public finance is called as functional finance because according to this view, public revenue and expenditure of the government are not to be considered as being governed solely by the requirements of government finances but by the requirements of attaining and maintaining full employment and price stability.

2.3.2 Objectives of Fiscal Policy

The importance of fiscal policy is high in underdeveloped countries. The state has to play active and important role. In a democratic society direct methods are not approved. So, the government has to depend on indirect methods of regulations. In this way, fiscal policy is a powerful weapon in the hands of government by means of which it can achieve the objectives of development. The principle objectives of fiscal policy are given below :

1. Development by Effective Mobilisation of Resources

The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by Mobilisation of Financial Resources..

The financial resources can be mobilised by :

A. **Taxation** : Through effective fiscal policies, the government aims to mobilise resources by way of direct taxes as well as indirect taxes because most important source of resource mobilisation is taxation.

B. **Public Savings** : The resources can be mobilised through public savings by reducing government expenditure and increasing surpluses of public sector enterprises.

C. **Private Savings** : Through effective fiscal measures such as tax benefits, the government can raise resources from private sector and households. Resources can be mobilised through government borrowings by ways of treasury bills, issue of government bonds, etc., loans from domestic and foreign parties and by deficit financing.

2. Efficient Allocation of Financial Resources

The central and state governments have tried to make efficient allocation of financial resources. These resources are allocated for development activities which includes expenditure on railways, infrastructure, etc. While non-development activities includes expenditure on defence, interest payments, subsidies, etc.

But generally the fiscal policy should ensure that the resources are allocated for generation of goods and services which are socially desirable. Therefore, India's fiscal policy is designed in such a manner so as to encourage production of desirable goods and discourage those goods which are socially undesirable.

3. Reduction in Inequalities of Income and Wealth

Fiscal policy aims at achieving equity or social justice by reducing income inequalities among different sections of the society. The direct taxes such as income tax are charged more on the rich people as compared to lower income groups. Indirect taxes are also more in the case of semi-luxury and luxury items, which are mostly consumed by the upper middle class and the upper class. The government invests a significant proportion of its tax revenue in the implementation of Poverty Alleviation Programmes to improve the conditions of poor people in society.

4. Price Stability and Control of Inflation

One of the main objective of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by reducing fiscal deficits, introducing tax savings schemes, productive use of financial resources, etc.

5. Employment Generation

The government is making every possible effort to increase employment in the country through effective fiscal measure. Investment in infrastructure has resulted in direct and indirect employment. Lower taxes and duties on small-scale industrial (SSI) units encourage more investment and consequently generates more employment.

6. Balanced Regional Development

Another main objective of the fiscal policy is to bring about a balanced regional development. There are various incentives from the government for setting up projects in backward areas such as cash subsidy, concession in taxes and duties in the form of tax holidays, finance at concessional interest rates, etc.

7. Reducing the Deficit in the Balance of Payment

Fiscal policy attempts to encourage more exports by way of fiscal measures like exemption of income tax on export earnings, exemption of central excise duties and customs, exemption of sales tax and octroi, etc.

The foreign exchange is also conserved by providing fiscal benefits to import substitute industries, imposing customs duties on imports, etc.

The foreign exchange earned by way of exports and saved by way of import substitutes helps to solve balance of payments problem. In this way adverse balance of payment can be corrected either by imposing duties on imports or by giving subsidies to export.

8. Capital Formation

The objective of fiscal policy is to increase the rate of capital formation so as to accelerate the rate of economic growth. An underdeveloped country is trapped in vicious circle of poverty mainly on account of capital deficiency. In order to increase the rate of capital formation, the fiscal policy must be efficiently designed to encourage savings and discourage and reduce spending.

9. Increasing National Income

The fiscal policy aims to increase the national income of a country. This is because fiscal policy facilitates the capital formation. This results in economic growth, which in turn increases the GDP, per capita income and national income of the country.

10. Development of Infrastructure

Government has placed emphasis on the infrastructure development for the purpose of achieving economic growth. The fiscal policy measure such as taxation generates revenue to the government. A part of the government's revenue is invested in the infrastructure development. Due to this, all sectors of the economy get a boost.

The objectives of fiscal policy such as economic development, price stability, social justice, etc. can be achieved only if the tools of policy like public expenditure, taxation, borrowing and deficit financing are effectively used.

The success of fiscal policy depends upon taking timely measures and their effective administration during implementation

2.3.3 Instruments of Fiscal Policy

Fiscal policy is an important instrument to stabilize the economy, that is, to overcome recession and control inflation in the economy. Fiscal policy through variations in government expenditure and taxation profoundly affects national income, employment, output and prices. An increase in public expenditure during depression add the aggregate demand for goods and services and leads to a large increase in income via the multiplier process, while a reduction in taxes has the effect of raising disposable income thereby increasing consumption and investment expenditures of the people. On the other hand, a reduction of public expenditure during inflation reduces aggregate demand, national income, employment, output and prices while an increase in taxes tends to reduce disposable income, and thereby reduces consumption and investment expenditures. Thus the government can control deflationary and inflationary pressures in the economy by a judicious combination of expenditure and taxation programmes.

Fiscal policy is of two kinds- Discretionary fiscal policy and non-discretionary fiscal policy of automatic stabilizers. By discretionary policy we mean deliberate change in the government expenditure and taxes to influence the level of national output and prices. Fiscal policy generally aims at managing aggregate demand for goods and services.

On the other hand, non-discretionary fiscal policy of automatic stabilizers is a built- in tax or expenditure mechanism that automatically increases aggregate demand when recession occurs and reduces aggregate demand when there is inflation in the economy without any special deliberate actions on the part of the government.

At the time of recession the government increases its expenditure or cuts down taxes or adopts a combination of both. On the other hand, to control inflation the government cuts down its expenditure or raises taxes. In other words, to cure recession expansionary fiscal policy and to control inflation contractionary fiscal policy is adopted. Fiscal policy aims at changing aggregate demand by suitable change in government spending and taxes. Thus, fiscal policy is mainly a policy of demand management. When the government adopts expansionary fiscal policy to cure recession, it raises its expenditure without raising taxes or cut down taxes without changing expenditure or increases expenditure and cuts down taxes as well. With the adoption of any of these types of expansionary fiscal policy government's budget will have a deficit. Thus expansionary fiscal policy to cure recession and unemployment is a deficit budget policy. On the other hand, to control inflation, government reduces its expenditure or increases taxes or adopts a combination of the two, it will be planning for a budget surplus. Thus policy of budget surplus or at least reducing budget deficit is adopted to remedy inflation.

The various instruments of fiscal policy are-

1. Budgetary Policy – Contra Cyclical Fiscal Policy

The budget is the principle instrument of fiscal policy. Budgetary policy exercises control over size and relationship of government receipts and expenditures. There are two common budget policies that can be adopted for stabilizing the economy.

A. **Budget Deficit-Fiscal Policy During Depression:**

Deficit budgeting is an important method of overcoming depression. When government expenditures exceed receipts, larger amounts are put into the stream of national income than they are withdrawn. The deficit represents the net expenditure of the government which increases national income by the multiplier times the increase in net expenditure. Thus the budget deficit has an expansionary effect on aggregate demand whether the fiscal process leaves marginal propensities unchanged or whether a redistribution of disposable receipts occurs.

Budget deficit may also be secured by reduction in taxes and without government spending. Reduction in taxes tends to leave larger disposable income in the hands of the people and thus stimulates increased consumption expenditure. This, in turn, would lead to increase in aggregate demand output, income and employment. However, reduction in taxes is not so expansionary via increased consumption expenditure because the tax relief may be saved and not spent on consumption.

B. Surplus Budget-Fiscal Policy During Boom:

Surplus in the budget occurs when the government revenues exceed expenditures. The policy of surplus budget is followed to control inflationary pressures with in the economy. It may be through increase in taxation or reduction in government expenditures or both. This will tend to reduce income and aggregate demand by the multiplier times the reduction in government and private consumption expenditure. There may be budget surplus without government spending when taxes are raised. Enhanced taxes reduce the disposable income with the people and encourage reduction in consumption expenditure. The result is fall in aggregate demand, output, income and employment.

2. Compensatory Fiscal Policy

The compensatory fiscal policy aims at continuously compensating the economy against chronic tendencies towards inflation and deflation by manipulating public expenditures and taxes. It, therefore, necessitates the adoption of fiscal measures over the long run rather than once for all measures at a point of time. When there are deflationary tendencies in the economy, the government should increase its expenditures through deficit budgeting and reduction in taxes. This is essential to compensate for the lack in private investment and to raise effective demand employment, output and income with in the economy. On the other hand, when there are inflationary tendencies, the government should reduce its expenditures by having a surplus budget and raising taxes in order to stabilize the economy at the full employment level.

The compensatory fiscal policies have two approaches – A.) Built – in stabilizers and , B.) Discretionary fiscal policy.

A. Built-in-Stabilizers :

The technique of built-in flexibility or stabilizers involves the automatic adjustment of the expenditures and taxes in relation to cyclical up swings and down swings with in the economy without deliberate action on the part of the government. Under this system changes in the budget are automatic and hence this technique is also known as one of automatic stabilization. The various automatic stabilizers are corporate profits tax, income tax, excise taxes, old age, survivors and unemployment insurance and unemployment relief payments. As instruments of automatic stabilization, taxes and expenditures are related to national income given an unchanged structure of tax rates, tax yields vary directly with movements in national income, while government expenditures vary inversely with variations in national income. In the downward phase of the business cycle when national income is declining, taxes which are based on a percentage of national income automatically decline, thereby reducing the tax yield. At the same time, government expenditures on unemployment relief and social security benefits automatically increase. Thus there would be an automatic budget deficit which would counteract deflationary tendencies. On the other hand, in the upward phase of the business cycle when national income is rising rapidly, the tax yield would automatically increase with the rise in tax rates. Simultaneously, government expenditures on unemployment relief and social security benefits automatically decline. These two forces would automatically create a budget surplus and thus inflationary tendencies would be controlled automatically.

B. Discretionary Fiscal Policy:

Discretionary fiscal policy requires deliberate changes in the budget by such actions as changing tax rates or government expenditures or both. It may generally take three forms: i) Changing taxes with government expenditure constant, ii) Changing government expenditure with taxes constant and iii) Variations in both expenditures and taxes simultaneously.

The First method is, when taxes are reduced, while keeping government expenditure unchanged, they increase the disposable income of household and businesses. This increases private spending, but the amount of increase will depend on whose taxes are cut, to what extent and on whether the tax payers regard the cut temporary or permanent. If the beneficiaries of tax cut are in the higher middle income group, the aggregate demand will increase much. It they belong to the lower income group, aggregate demand will not increase much. It they are businessmen with little incentives to invest, tax reduction will not induce them to invest. Lastly, if the tax payers regards tax reductions as temporary, this policy will again be less effective so this policy is more effective in controlling inflation by raising taxes because high rate of taxation will reduce disposable income of individuals and businesses there by curtailing aggregate demand.

The second method is more useful in controlling deflationary tendencies, when the government increases its expenditure on goods and services, keeping taxes constant, aggregate demand goes up by the full amount of the increase in government spending. On the other hand, reducing government expenditure during inflation is not so effective because of high business expectations in the economy which are not likely to reduce aggregate demand.

The third method is more effective and superior to the other two methods in controlling inflationary and deflationary tendencies. To control inflation, taxes may be increased and government expenditure reduced. On the other hand, taxes may be increased and government expenditure be raised to fight depression.

To conclude that automatic stabilizers reduce the intensity of business fluctuations, that is both recession and inflation, however, the automatic or built-in stabilizers cannot alone correct the recession and inflation significantly.

Therefore, The role of discretionary fiscal policy, namely, deliberate and explicit changes in tax rates and amount of government expenditure are required to cure recession and curb inflation.