Understanding your financial world

Fiscal Policy

Fiscal policy is about the taxation and discretionary spending decisions that a government makes. Those decisions include the day-to-day spending a government needs to make on services like health care and education, the economic direction of the country and how they will be funded, either through taxes or government borrowing. Fiscal policy, therefore, relates to the government's **Budget**.

Budget

The government's Budget is the record of its revenues (mainly from taxation, duties the profits of State-owned Enterprises (SOEs) and its expenditures (such as healthcare, education, infrastructure, social welfare, etc.)

(adapted from Stewart and Rankin, 2008, p.338)

Using Fiscal Policy for meeting Government Objectives

Most governments generally aim to achieve:

- Sustainable economic growth
- Low inflation
- Full employment
- A balanced current account
- Equitable distribution of income

but achieving all of the above simultaneously is a hard act. Sometimes, trying to achieve one or more of the objectives can have a detrimental effect on other objectives. One tool that governments use to balance these objectives is fiscal policy. It uses fiscal policy to influence the level of activity in the economy. This is known as *demand management* or *fine-tuning*.

Fiscal policy can be *expansionary* which involves governments increasing its spending or reducing taxes. This will increase a *budget deficit* or reduce a *budget surplus*. A *contractionary* fiscal policy is the opposite; reducing government spending or increasing taxation.

Adapted from Stewart, J. and Rankin, K. (2008). *Economic concepts and applications: The contemporary New Zealand environment*, 4th ed. Pearson: Auckland, New Zealand

Budget surplus

The excess of government revenue over government expenditure.

Budget deficit

The opposite of budget surplus; an excess of government expenditure over government revenue (in other words, a negative budget surplus).

(adapted from Stewart and Rankin, 2008, p.338)

Expansionary fiscal policy

An increase in government spending, or a decrease in taxes or both, designed to increase the level of demand for goods and services in the economy (known as *aggregate demand*).

Contractionary fiscal policy

A decrease in government spending, or an increase in taxes or both, designed to reduce the level of aggregate demand.

(adapted from Stewart and Rankin, 2008, p.338)

Implications of Taxation and Government Spending

The main source of funding for government spending is taxation. If more money is taken from the economy to be spent by government, less is available for the private sector to spend on investment and consumption. Conversely, if governments spend too little on public services, households have more to spend but the quality and quantity of public services may diminish. Whether government spending is too little or too large is a judgement that you can make by comparing taxation levels in other countries and the services that governments provide.

Connecting Balance of Payments, Foreign Exchange Rates and Fiscal Policy

If a government has a surplus, its 'savings' are available for the private sector to use for investing (in new equipment, for example) and if a government is running a deficit it can draw on private savings (borrow from the private sector) to fund its deficit. If there is not enough private saving in New Zealand, the government must borrow from overseas private savers (with consequent impact on the balance of payments and foreign exchange rates).

Adapted from Stewart, J. and Rankin, K. (2008). *Economic concepts and applications: The contemporary New Zealand environment*, 4th ed. Pearson: Auckland, New Zealand

Limitations of Fiscal Policy Fine Tuning

Fiscal policy can be used to stimulate the economy after a period of recession or dampen down the level of economic activity if the economy is growing too fast. This manipulation of government spending and taxation, however, has limitations:

- Increased government spending increases the demand for money and 'crowds out' private sector investment
- The time lag or delay in getting economic indicators means that the impact of fiscal policy is too late and may exaggerate rather than moderate the upswing or downswing in economic activity
- High government debt levels or persistent government deficits may limit how much government spending is possible and, therefore, the ability to use fiscal policy for economic expansion
- Government may have conflicting priorities, such as limiting inflation, that may prevent expansionary policies
- Contractionary policies may be potentially politically damaging and governments may be afraid to adopt them (e.g. Greece, Italy, Spain . . .)
- The election cycle may mean that political objectives take priority over economic objectives.

Adapted from Stewart, J. and Rankin, K. (2008). *Economic concepts and applications: The contemporary New Zealand environment*, 4th ed. Pearson: Auckland, New Zealand