What Is Fiscal Policy?

-By Reem Heakal on October 09, 2013
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Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. It is the sister strategy to monetary policy through which a central bank influences a nation's money supply. These two policies are used in various combinations to direct a country's economic goals. Here we look at how fiscal policy works, how it must be monitored and how its implementation may affect different people in an economy.

Before the Great Depression, which lasted from Sept. 4, 1929 to the late 1930s or early 1940s, the government's approach to the economy was laissez-faire. Following World War II, it was determined that the government had to take a proactive role in the economy to regulate unemployment, business cycles, inflation and the cost of money. By using a mix of monetary and fiscal policies (depending on the political orientations and the philosophies of those in power at a particular time, one policy may dominate over another), governments are able to control economic phenomena.

How Fiscal Policy Works

Fiscal policy is based on the theories of British economist John Maynard Keynes. Also known as Keynesian economics, this theory basically states that governments can influence macroeconomic productivity levels by increasing or decreasing tax levels and public spending. This influence, in turn, curbs inflation (generally considered to be healthy when between 2-3%), increases employment and maintains a healthy value of money. Fiscal policy is very important to the economy. For example, in 2012 many worried that the fiscal cliff, a simultaneous increase in tax rates and cuts in government spending set to occur in January 2013, would send the U.S. economy back to recession. The U.S. Congress avoided this problem by passing the American Taxpayer Relief Act of 2012 on Jan. 1, 2013.

Balancing Act

The idea, however, is to find a balance between changing tax rates and public spending. For example, stimulating a stagnant economy by increasing spending or lowering taxes runs the risk of causing inflation to rise. This is because an increase in the amount of money in the economy, followed by an increase in consumer demand, can result in a decrease in the value of money - meaning that it would take more money to buy something that has not changed in value.

Let's say that an economy has slowed down. Unemployment levels are up, consumer spending is down and businesses are not making substantial profits. A government thus decides to fuel the economy's engine by decreasing taxation, which gives consumers more spending money, while increasing government spending in the form of buying services from the market (such as building roads or schools). By paying for such services, the government creates jobs and wages that are in turn pumped into the economy. Pumping money into the economy by decreasing taxation and increasing government spending is also known as "pump priming." In the meantime, overall unemployment levels will fall.

With more money in the economy and fewer taxes to pay, consumer demand for goods and services increases. This, in turn, rekindles businesses and turns the cycle around from stagnant to active.

If, however, there are no reins on this process, the increase in economic productivity can cross over a very fine line and lead to too much money in the market. This excess in supply decreases the value of

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money while pushing up prices (because of the increase in demand for consumer products). Hence, inflation exceeds the reasonable level.

For this reason, fine tuning the economy through fiscal policy alone can be a difficult, if not improbable, means to reach economic goals. If not closely monitored, the line between a productive economy and one that is infected by inflation can be easily blurred.

And When the Economy Needs to Be Curbed …

When inflation is too strong, the economy may need a slowdown. In such a situation, a government can use fiscal policy to increase taxes to suck money out of the economy. Fiscal policy could also dictate a decrease in government spending and thereby decrease the money in circulation. Of course, the possible negative effects of such a policy in the long run could be a sluggish economy and high unemployment levels. Nonetheless, the process continues as the government uses its fiscal policy to fine-tune spending and taxation levels, with the goal of evening out the business cycles.

Who Does Fiscal Policy Affect?

Unfortunately, the effects of any fiscal policy are not the same for everyone. Depending on the political orientations and goals of the policymakers, a tax cut could affect only the middle class, which is typically the largest economic group. In times of economic decline and rising taxation, it is this same group that may have to pay more taxes than the wealthier upper class.

Similarly, when a government decides to adjust its spending, its policy may affect only a specific group of people. A decision to build a new bridge, for example, will give work and more income to hundreds of construction workers. A decision to spend money on building a new space shuttle, on the other hand, benefits only a small, specialized pool of experts, which would not do much to increase aggregate employment levels.

The Bottom Line

One of the biggest obstacles facing policymakers is deciding how much involvement the government should have in the economy. Indeed, there have been various degrees of interference by the government over the years. But for the most part, it is accepted that a degree of government involvement is necessary to sustain a vibrant economy, on which the economic well-being of the population depends.