Glossary entry: fiscal policy

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I realised yesterday that there was no entry on fiscal policy in this blog's glossary. As a result, I made good that omission with the following entry:

Fiscal policy is a term used to describe one of the two most common approaches adopted by a government towards macroeconomic management of the economy for which they are responsible, the other being monetary policy.

Fiscal policy uses the management of government expenditure and taxation income to, in combination, either stimulate or suppress economic activity within a jurisdiction.

Based upon the ideas of the 20th-century British economist, Lord John Maynard Keynes, fiscal policy suggests that if a government wishes to stimulate economic activity because, for example, there is significant unemployment or under-employment in a jurisdiction, then it will spend more money into the economy than it raises in taxation revenue, with the reverse being true if it wishes to suppress activity because, for example, it thinks markets are overheated and there is a risk of inflation.

The inherent logic implicit in fiscal policy is that government expenditure in excess of government taxation revenue stimulates economic activity whilst this situation persists, with the reverse having a dampening effect on economic activity.

Fiscal policy is finessed by deciding upon the mix between government revenue expenditure, i.e. that which is incurred for immediate purposes, and government capital expenditure, i.e. that which represents investment for long-term benefit. These two types of expenditure tend to have different fiscal multiplier effects, with government capital expenditure usually generating greater long-term taxation benefits for a government than current revenue expenditure does.

Fiscal policy can also be finessed by altering which taxes are increased or lowered within the economy. Reducing taxes on those with the lowest pay tends to have a higher fiscal multiplier effect with, as a result, more and more immediate fiscal policy impact than reducing taxes for those with the highest levels of income and gains does. That is because those with lower incomes tend to spend the benefit of any tax cuts that they receive almost immediately, whilst those with higher incomes and gains tend not to spend the benefit of tax cuts that they enjoy but save them instead, producing, as a result, smaller fiscal multiplier effects. In both cases, the reverse is also true.

As the previous paragraph makes clear, because government expenditure and government taxation revenue are not independent variables because government spending does invariably give rise to activity that is subject to taxation, fiscal policy management can never be a precise science. The resulting imprecision in fiscal policy management is exacerbated by the delay that exists within any economy between the announcement of policy, the undertaking of expenditure, and the consequent changes in taxation revenue. These delays create inherent uncertainty in fiscal policy management.

Keynes created the concept of fiscal policy because he correctly noted that markets do not by themselves, and without government invention, necessarily deliver conditions of full employment in any economy. Keynes thought full employment to be the goal of macroeconomic management, particularly given the experience of economies in the inter-world-war era.

Every modern government of any size does now necessarily consider its fiscal policy when managing its affairs and those of the economy for which it is responsible. Many will, however, also seek to manage the continuing fiscal cycles of relative boom and depression that occur despite their doing so through the use of monetary policy. This seeks to control the scale of short-term economic activity by the use of artificial movements in interest rates set by the government. They do so despite the evidence of the success of monetary policy being limited. In contrast, there can be no doubt that the post-1945 growth in economies around the world has arisen because of the use of fiscal policies and the implicit desire for full employment inherent within it.

This post adds to other glossary entries on:

* *Fiscal rules*

* *Fiscal choices*

* *Fiscal space*