FISCAL POLICY

INTRODUCTION

- Fiscal policy: deliberate management of government spending and taxation designed to influence the level of economic activity in order to achieve the economic goals of the government
- Economic goals
  - Macroeconomic: smooth out ever-present fluctuations in economic activity; promote EG; full employment; price stability
  - Microeconomic: efficiency, equity
- Fiscal policy tool: Budget
  - Government plans expenditure and revenue
  - Fiscal positions
    - Budget surplus: T>G → contractionary FP, austerity measures
    - Budget balance: T=G
    - Budget deficit: T<G → expansionary FP
  - Government revenue
    - Sale of g/s
      - State enterprises, investments in securities, licence fees and fines
    - Taxation: compulsory payments from the private sector to the government
      - Direct
        - Personal Y tax, corporate tax
        - Taxes on Y and wealth; impact and incidence on the same party
      - Indirect
        - GST
        - Taxes on expenditure or pdn of g/s
        - Impact: producers; Incidence: burden shared with consumer
      - Tax systems
        - Proportional tax: same prop of Y as Y rises (eg. corporate tax)
        - Progressive tax: rate of tax increases as Y rises → larger prop of Y from the rich than the poor → reduces post tax income differentials (eg. personal Y tax)
        - Regressive tax: rate of tax decreases as Y increases → smaller prop of Y from rich than poor (eg. indirect taxes on g/s)
      - Economic Effects of Taxes
        - Incentive to work
          - Income effect: higher T → Yd falls → to maintain consumption, work more hours → encourage people to work more
          - Substitution effect: higher T → an hour's work buys less consumption → encourage absenteeism; discourage overtime work → work less
          - Net effect uncertain. If a worker has more commitments (eg. children, mortgages), income effect dominates.
        - Incentive to take risks
          - Corporate tax → reduce post-tax profits which are rewards for risk-taking → disincentive for enterprise and pdn
          - Impt due to high degree of capital mobility and competitive corporate tax rates in the region
        - Resource Allocation

            - Taxes and tax incentives/deductions influence pdn of various types of g/s and the supply of various types of labour
        - Savings
            - High taxes → reduce ability and willingness to save → reduce loanable funds available for capital formation/investment
        - Investments
            - Lower corporate tax → increase financial capital available for I
        - Inflation
            - Indirect tax: increase P of g/s → increase cost of living → workers DD for higher wages → inflationary spiral
            - Direct tax: reduces Yd → reduces DD → reduces P of g/s (deflationary)
                - But unions may DD higher wages
    - Government Expenditure
        - Types of Expenditure
            - Operating expenditure: day-to-day expenditure; recurrent
                - General administration, economic/social/community services, servicing national debt
            - Development expenditure: economic and social development
            - Economic Effects
                - Resource Allocation
                    - G can affect pattern of production
                - Y and wealth distribution
                    - G on healthcare/education/social welfare + progressive Y tax → reduce Y/wealth inequalities
                - EG
                    - Infrastructure development (tpt/comms facilities) → attract productive investments (increase AS) + increase AD
                - Internal stability: influence level of economic activity

NON-DISCRETIONARY FISCAL POLICY

- Built-in Stabilisers: automatic changes in T and G, not by deliberate govt action
- Counter-cyclical effect: reduces (but NOT eliminate) fluctuations in an economy
- Examples of built-in stabilisers
    - Progressive tax structure
        - Boom: tax payments increase faster than increase in incomes → increased tax revenue → extra withdrawals exert contractionary impact
        - Recession: tax revenue falls → slows down fall in C and AD
    - Unemployment compensation/Family assistance programme
        - Tied to income levels
        - Boom: less benefits → contractionary impact
        - Recession: more benefits → expansionary impact

DISCRETIONARY FISCAL POLICY

- Deliberate change in G and T → desired change in AD
- Fiscal stance: expansionary or contractionary

LIMITATIONS OF FISCAL POLICY

DISCRETIONARY FP

- Size of multiplier
    - Size of k affects extent of increase in RNY. Smaller k implies that govt needs high G → high opp cost → unsustainable in LR
- Time Lags
    - Recognition lag
    - Administrative lag: time taken to plan, design and pass new policies through govt mechanisms
    - Operational lag: time taken between implementation and impact (eg. change in I requires planning time, k process takes time to work)
- Financial crowding out of domestic investment by firms
    - Govt borrows money from non-bank private sector → competes for scarce funds with private sector → raises i/r → raises cost of borrowing → by MEI theory, I falls + h/hs reduce C of consumer durables like cars and housing → net increase in AD is by a smaller extent
    - Eventual RNY depends on relative extent of k effect vs crowding out effect
    - SG CONTEXT: not applicable as Sg govt does not borrow money as it has past budget surpluses
- Crowding out of net exports in an open economy
    - Assuming flexible e/r system and free capital mobility,
    - Govt borrows money → i/r increase → attract hot money inflows → DD for ctry's currency rises → currency appreciates → X more expensive in foreign currencies; reduced export competitiveness + M cheaper in domestic currency → Qd of X falls + Qd of M rises as consumers switch to cheaper M subs → assuming MLC, net exports fall → reduce full extent of increase in AD due to increase in G
- Burden on future SOL
    - Increase in national debt → higher tax rates in the future
    - Internal debt: repayment involves transfer of wealth from taxpayers to bond holders → worsen Y distribution
    - External debt: repayment involves outflows from BOP
- Political pressures from lobby groups to have EFP which are more politically attractive
- Difficulty in forecasting outcome of fiscal measures
    - Difficult to estimate size of k
        - MPC fluctuates, depends on households' expectations abt future price/Y
        - MPM fluctuates according to e/r
- Inflexibility/Lack of reversibility
- Policy conflicts
    - EG, employment vs inflation, BOP

NON-DISCRETIONARY FP

- Adverse supply-side effects
    - High tax rates discourage work effort and initiative → lowers productivity
    - High unemployment benefits → reduce opp cost of being unemployed → increase frictional unemployment
- Fiscal drag
    - Contractionary effect of increased tax revenues produced by increases in national income

- EFP → RNY rising → tax revenues rise + G on transfer payments falls → Yd falls → C falls → drag on growth of AD

FISCAL POLICY IN SINGAPORE

- Prudent expenditure patterns and conducive taxation policies
- Expenditure mainly on essential public g/s
- Tax policies seek to enhance economic competiveness, attract foreign investments/talent
- Fiscal prudence and ethos of fiscal rectitude (honest and honourable handling of govt finances by public sector) → consistent budget surpluses over the years
- High savings rate → high investment
- High level of foreign reserves → boosts investor confidence, provides buffer against economic shocks
- Short implementation lags due to small size and efficient institutions (eg. tax and CPF systems)