

TYPES OF FISCAL AND MONETARY POLICIES TO BE OPTIMAL FOR STIMULATING ECONOMIC GROWTH

Allayarov Sukhrob

Senior lector department of Finance at Tashkent Institute of Finance

Abstract - This article explores the main types of fiscal and monetary policies, their goals and objectives, and the role of fiscal and monetary policies in improving the country's economy.

Index terms - GDP, tax, inflation, consumption, investment, government spending, net export, fiscal policy, monetary policy, expansionary fiscal policy, contractionary fiscal policy.

INTRODUCTION

The rapid-growth and transition nature of the economy reflects not only the need for openness of the economy, but also the fact that the implementation of fiscal and monetary policies essentially depends on the state of the balance of payments. If exports are a significant part of GDP, then the revenues of the state budget will also depend to a large extent on export earnings, which is an important restriction on fiscal policy. In a situation where the current account surplus cannot be balanced by the capital account at this exchange rate, in the absence of large-scale central bank interventions in the foreign exchange market, the exchange rate of the national currency should strengthen. In these conditions, monetary policy is forced to choose between the accumulation of gold and currency reserves in order to maintain the exchange rate, which allows to achieve an increase in GDP, and to contain inflation. In addition, the underdevelopment of financial markets, characteristic of many developing economies of export-oriented (resource) type, also imposes certain restrictions on the possibility of using traditional instruments of fiscal and monetary policy.

Literature review

According to famous economist, David N. Weil Fiscal policy is an important tool for managing the economy because of its ability to affect the total amount of output produced—that is, gross domestic product. The first impact of a fiscal expansion is to raise the demand for goods and services. This greater demand leads to increases in both output and prices. The degree to which higher demand increases output and prices depends, in turn, on the state of the business cycle. If the economy is in recession, with unused productive capacity and unemployed workers, then increases in demand will lead mostly to more output without changing the price level. If the economy is at full employment, by contrast, a fiscal expansion will have more effect on prices and less impact on total output[1].

According to Indian economist Supriya Guru, monetary policy is another important instrument with which objectives of macroeconomic policy can be achieved. It

is worth noting that it is the Central Bank of a country which formulates and implements the monetary policy in a country. In some countries such as Uzbekistan the Central Bank works on behalf of the Government and acts according to its directions and broad guidelines. However, in some countries such as the USA the Central Bank (i.e., Federal Reserve Bank System) enjoys an independent status and pursues its independent policy. Like the fiscal policy the broad objectives of monetary policy are to establish equilibrium at full-employment level of output, to ensure price stability and to promote economic growth of the economy[2].

Research methodology

The subject of the research is devoted to the fiscal and monetary policy studied the scientific works of the economist who conducted the research on this subject. There are used his/her views on policies, as well as generalization, comparative analysis methods.

Analysis of the research results

Fiscal and monetary policy tools across countries and their economic structure which can be seen as the key reason of differentiating prerequisite and conditions to support the economic development. There are many theoretical views that attempt to explain the requirements to enable growth-forwarding effect of fiscal and monetary policy measures. However, the most reliable and proven concept is the GDP formulation theory, which simultaneously reflects the impact of fiscal and monetary policy effects in economic growth. This classical theory postulates that if any element of the $C + I + G + (E_x - I_m)$ formula increases, then GDP—total demand—increases. If the “G” portion—government spending at all levels—increases, then GDP increases. Similarly, if government spending decreases, then GDP decreases. When it comes to financial management, four characteristics of the government set

it apart from households and businesses (the “C” and “I” in the formula).

The tax base in a nation, region, state, or city is the number of workers and businesses who can be taxed. The term usually refers to income taxes, but in the case of states and cities, it also refers to sales and property taxes.

Bracket creep occurs when inflationary pressure increases wages and pushes a worker into a higher tax bracket. This puts a “double whammy” on the worker, who loses purchasing power – wage-push inflation often increases prices faster than wages – and pays more in taxes. But it helps keep inflationary pressures under control:

- Government has the power to tax, which gives it greater control over its revenue. Central, state, and local governments can mandate higher taxes and increase their revenues. Households and businesses have the more difficult task of selling their labor, goods, and services in order to raise revenue.
- By increasing or decreasing taxes, the government affects households' level of disposable income (after-tax income). A tax increase will decrease disposable income, because it takes money out of households. A tax decrease will increase disposable income, because it leaves households with more money. Disposable income is the main factor driving consumer demand, which accounts for two-thirds of total demand.
- The central government can print more money. Like raising taxes, this has potential economic consequences (in the form of higher inflation) as well as political consequences. Nevertheless, the central government does have that option, which is certainly not open to households and businesses.

These unique characteristics set the government apart from the other players in the economy. They also position the central government to formulate and implement economic policy. Fiscal policy is the general name for the central government's taxation and expenditure decisions and activities, particularly as they affect the economy. Monetary policy refers to policies that affect interest rates and the money supply. Figure 1. shows how $C + I + G$ add up to determine the equilibrium level of GDP. (For convenience, we're assuming that net exports ($Ex - Im$) are zero.) Line “C” represents consumption by consumers. Line “C+I” represents consumption by consumers plus investment by businesses. Line “C+I+G” represents consumption plus investment plus government spending [3].

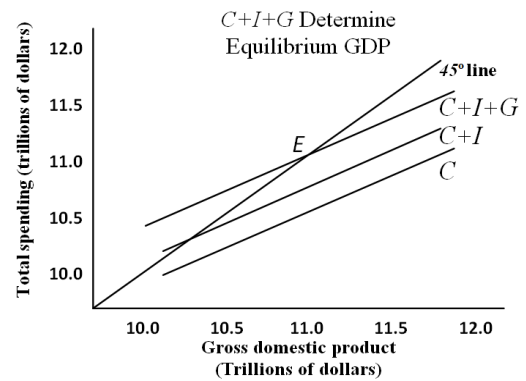


Figure 1. Economic growth fundamentals

Source: *The Complete Idiot's Guide to Economics* © 2003 by Tom Gorman.

The 45 degree line shows all the points at which total spending equals gross domestic product. At any point on that line, the quantity demanded by the households, businesses, and government in the economy (total spending) equals the amount being produced (GDP). Whenever total demand equals total spending, the economy is in equilibrium.

Where is the actual equilibrium point for the economy? Where the total demand of households, businesses, and government “ $C + I + G$ ” equals their production. That equilibrium point occurs where the line $C + I + G$ intersects the 45 degree line. At that point, which is point “E” on the chart, total spending (total demand) and total production (GDP) are equal.

Figure 1. ignores taxes, but they are a crucial element in fiscal policy. Taxes lower households' disposable income. The amount collected in taxes doesn't find its way into consumption (“C”). But if the government spends every dollar that it collects in taxes, then that amount does find its way into total demand through government expenditures. When that occurs, the GDP remains unaffected by taxes. The size of the economy is the same whether people choose to produce and consume private goods (angora sweaters) or public goods (army uniforms). The mix of goods doesn't affect the level of GDP, as long as the total amount spent on them doesn't change.

Total spending—and therefore the equilibrium level of GDP—decreases. Suppose that the money for army uniforms is collected but not spent. In that case, there's no need to manufacture the uniforms, no need to staff the uniform factory, and no need to pay the workers, who now have less income to devote to consumption.

In general, when the government brings in more in taxes than it spends, it reduces disposable income and slows the growth of the economy. So, the fiscal policy prescription to stabilize an overheated economy is higher taxes. In times of inflation a tax increase, coupled with no increase in government spending, will dampen the upward pressure on prices.

The tax increase lowers demand by lowering disposable income. As long as that reduction in consumer demand is not offset by an increase in government demand, total demand decreases.

A decrease in taxes has the opposite effect on income, demand, and GDP. It will boost all three, which is why people cry out for a tax cut when the economy is sluggish. When the government decreases taxes, disposable income increases. That translates to higher demand (spending) and increased production (GDP). So, the fiscal policy prescription for a sluggish economy and high unemployment is lower taxes.

Spending policy is the mirror image of tax policy. If the government were to keep taxes the same, but decrease its spending, it would have the same effect as a tax increase, but through a slightly different channel. Instead of decreasing disposable income and decreasing consumption ("C"), a decrease in government spending decreases the "G" in $C + I + G$ directly. The lower demand flows through to the larger economy, slows growth in income and employment, and dampens inflationary pressure. Likewise, an increase in government spending will increase "G" and boost demand and production and reduce unemployment.

Fiscal Policy Prescriptions

	Taxes	Spending
Overheated Economy (high demand and inflation)	Increase	Decrease
Sluggish economy (low demand and high unemployment)	Decrease	Increase

Figure 2. Fiscal policy and economic growth interrelations

Source: *The Complete Idiot's Guide to Economics* © 2003 by Tom Gorman.

To dampen economic growth and inflationary pressure, the government can increase taxes and keep spending constant, or decrease spending and keep taxes constant. To stimulate growth and reduce unemployment, the government can decrease taxes and keep spending constant, or increase spending and keep taxes constant.

Finally, the government can pursue its fiscal policy objectives more aggressively by simultaneously adjusting both taxes and spending. For instance, in a sluggish economy, the government could decrease taxes and increase spending at the same time. Each could be adjusted either by small amounts, so that neither taxes nor spending are changed too radically, or by large amounts to deliver a stronger dose of fiscal stimulus. Similarly, in an overheated economy, the government could increase taxes and decrease spending, if it wanted to dampen growth (and enrage voters). To keep things simple, the previous section omitted three other aspects of fiscal policy: the automatic stabilizing

influence of fiscal policy, the multiplier effect, and the propensity to spend or save. First, fiscal policy exerts an automatic stabilizing effect on the economy, even when the government makes no explicit changes in its tax or spending plans.

When the economy contracts, tax receipts automatically decrease (because incomes decrease). This effect is magnified by progressive taxation, our system applying higher tax rates to higher incomes. Workers who are laid off or lose their overtime pay automatically fall into a lower tax bracket. Their lower taxes bills will partially offset the effect of their lost income. Similarly, when incomes rise, particularly during inflation, bracket creep pushes people into higher tax brackets. The higher taxes they pay tax money out of their pockets -money they can no longer use to bid prices up even higher. Government spending also acts as an automatic stabilizer, especially during downturns. The central government tends to maintain its general level of spending during recessions, which ensures a solid baseline level of demand from the "G" in $C + I + G$. Also, programs of unemployment insurance and public assistance help to ease the burden of tough times on households.

Second, the multiplier will boost the effect of an increase or reduction in taxes or spending. For instance, an extra dollar of government spending will flow through the economy and, by being repeatedly re-spent, will magnify the stimulus provided by that incremental dollar. Likewise, a dollar of reduced spending will take a dollar out of the economy, and the multiplier applies to that as well.

Finally, like the multiplier, the propensities to spend and to save are at work. If the government reduces taxes to stimulate consumption, but households save the money rather than spend it, consumption will not rise, nor will investment. If people save the money, they are "sitting on their wallets" and consumption remains low. If consumption is low, businesses won't invest. This has been a problem in the application of fiscal stimulus in Japan, where people tend to save increases in income.

As discussed above, recent development in global fiscal monetary policy trends show that all governments may choose either one of the two types: contractionary or expansionary. Contractionary fiscal and monetary policy is characterized with protectionist behavior. In times of inflation, fiscal policy takes the classic measures like reduction of spending and increasing taxes. Contractionary monetary policy is characterized with the same behaviors with traditional actions such as increasing key interest rate, reserve requirements and tightening (See Figure 3) [4].

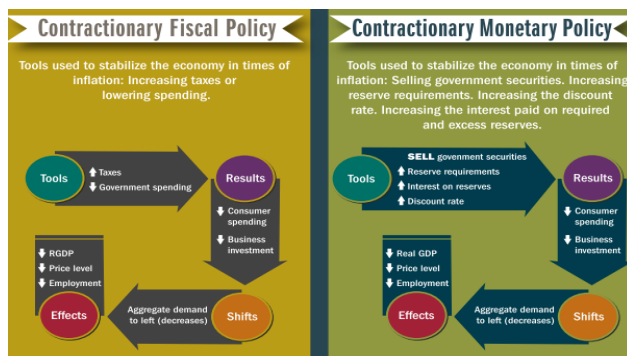


Figure 3. Contractionary monetary and fiscal policy
Source: Classroom Economist info graphic for Fiscal & Monetary Policy

The last time that United States has used a contractionary fiscal policy was in the late 1960s. This was a time when the country was experiencing demand-pull inflation due mainly to government spending. The government was spending on the Vietnam War and was also trying to maintain domestic spending on the “Great Society” programs that had been pushed by President Lyndon Johnson. All of this government spending led to inflation.

In order to combat this, both President Johnson and his successor, Richard Nixon, used contractionary fiscal policy. In 1968, Johnson imposed a 10% tax surcharge on American taxpayers. Nixon ordered reductions in government purchasing. In both cases, what the presidents were trying to do was to reduce the amount of money in the consumer’s pockets so as to reduce aggregate demand and lower inflation. In contrast, expansionary fiscal and monetary policy is innovative, open and modern which is flexible and efficient in extreme cases. Expansionary monetary policy avoids traditional solutions like lowering the reserve requirements, discount rate and money supply. Expansionary fiscal policy stimulates the economy and invests in extremely harsh macroeconomic condition to rescue national economy (See Figure 4).

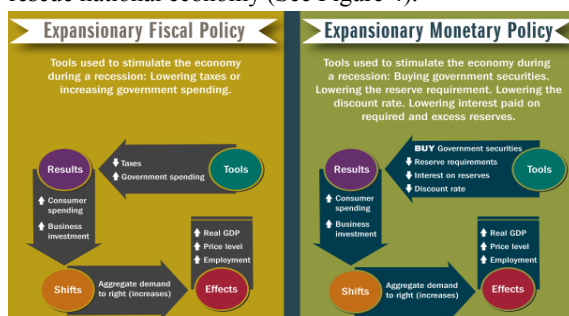


Figure 4. Expansionary fiscal and monetary policy
Source: Classroom Economist info graphic for Fiscal & Monetary Policy

The government attempts to bridge the reduction in demand by giving a windfall to citizens via a tax cut or an increase in government spending, which creates jobs and alleviates unemployment. An example

of such an effort is the Economic Stimulus Act of 2008, in which the government attempted to boost the economy by sending taxpayers \$600 or \$1,200 depending on their marital status and number of dependents. The total cost was \$152 billion. Tax cuts are favored by conservatives for effective expansionary fiscal policy, as they have less faith in the government and more faith in markets.

Liberals tend to be more confident in the ability of the government to spend judiciously and are more inclined towards government spending as a means of expansionary fiscal policy. An example of government spending as expansionary fiscal policy is the American Recovery and Reinvestment Act of 2009. This effort was taken on in the midst of the Great Recession and totaled \$831 billion. Most of this spending targeted infrastructure, education and extension of unemployment benefits.

All in all, optimal fiscal and monetary policy may use the tools of both types depending on the stance of financial and macroeconomic conditions. However, expansionary policy has become the commonly preferred is last couple of decades due to flexibility and commonness. In terms of optimality to support economic growth, expansionary monetary and fiscal policy has more channels than contractionary one (see Figure 5).

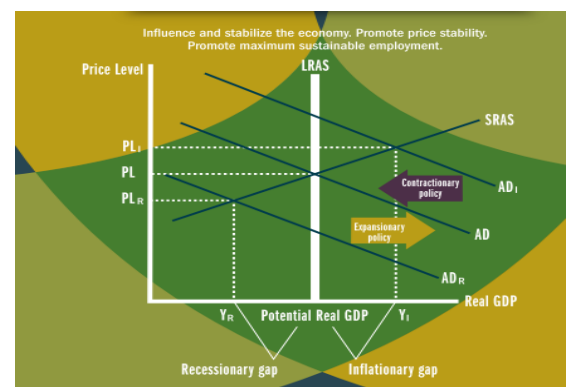


Figure 5. Interaction of optimal fiscal and monetary policy for boosting economic growth
Source: Classroom Economist info graphic for Fiscal & Monetary Policy

Optimality of an item often determines the maximum advantage and minimum disadvantage of the selected item’s impact or state. Optimality of fiscal and monetary policy roots from classical views aligned with modern methods and solutions. Optimal monetary policy can be referred as the critically highest level of benefit and lowest level of negative effect of the policy on economic growth. Optimal Fiscal policy can be referred as the most favorable stance of tax level and public financial stability, which can stimulate the economic growth at full spectrum.

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