CENTRAL BANK of SOLOMON ISLANDS

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GOVERNMENT BUDGET - Understanding the Role Government Budget Plays in Fiscal policy

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In this topic we look at government budget and the role it plays in fiscal policy. We then look at how fiscal policy can affect the economy.

What is the government budget?

The budget is a government's annual spending plan. The level of revenue is estimated and then the level of spending is decided. When we looked at government debt, a budget may be balanced, revenue equal spending, or unbalanced, meaning spending is more or less than revenue. When revenue exceeds expenditure, it is called a budget surplus and when expenditure exceeds revenue it is considered a budget deficit.

In the budget, the total level of spending is set and then divided between the different Ministries such as the Ministry of Health, Ministry of Foreign Affairs and External Trade etc. In this way, the budget acts as a spending plan for each Ministry which then directs the money for general expenditures (recurrent spending) and for projects approved by the Ministry (development spending). The budget also helps the public see how the government uses the taxes it collects.

The 2021 government budget is an unbalanced budget with an estimated budget deficit of $322 million. This reflects a total estimated expenditure of $4,098 million which is higher than total estimated revenue of $3,776 million.

How is a budget deficit financed?

There are two ways to cover a budget deficit. First, the government may withdraw from its accumulated deposits, if it has enough savings, and second, it can borrow from the public. The government can borrow internally from local firms, banks and the public. Or it can borrow externally from foreign governments and multilateral organisations such as the World Bank and the Asian Development Bank.

For the 2021 budget, government intends to fund the expected budget deficit of $322 million through borrowing.

A budget deficit may lead to build-up in government debts whilst a budget surplus can help to paydown government debt. If debt becomes too large for a country's repayment ability it could lead to poor allocation of resources within the budget and slow down economic growth. Generally, the size of the budget and whether it is a balanced or unbalanced budget reflects the government's fiscal policy.

What is Fiscal Policy?

Fiscal policy is the use of government spending and taxation to influence the economy. Therefore, the budget gives the public information regarding the government's fiscal policy.

When the term fiscal policy is used, it is usually used to describe the overall effect of spending and taxation on the economy or more importantly the gap between spending and revenue collection levels.

Fiscal policy is said to be contractionary when levels of spending are below overall levels of revenue collection and expansionary when spending levels exceed levels of revenue collection. But, also the change in the deficit or surplus is deemed contractionary or expansionary. If one-year spending is greater than revenue we might say that the government is implementing an expansionary fiscal policy. The next year however, when spending is reduced but still greater than total revenue we say that the government is implementing a contractionary fiscal policy.

How does Fiscal Policy affect the economy?

Fiscal policy can be used to affect aggregate demand in the economy either through spending or taxes.

If a government increases spending whilst leaving tax levels the same, demand in the economy will increase. Either, the government is directly purchasing greater quantities of goods and services raising demand for goods and services in the economy, or the government is employing more people who, in turn, are purchasing goods and services with their wages. On the other hand, if government spending decreases whilst leaving taxes the same, it will reduce overall demand in the economy.

On the taxation side, if the government increases taxes whilst leaving spending the same, people and firms in the economy will have less money to spend on goods and services. Because they must now contribute more of their wages or profits to the government it will therefore reduce aggregate demand in the economy. If, on the other hand, the government reduces taxes whilst keeping spending the same, people and businesses would pay less taxes than before and use this additional money to purchase goods and services boosting aggregate demand.

Fiscal policy directly or indirectly influences aggregate demand. A basic equation of national income accounting that measures the output of an economy—or gross domestic product (GDP)—according to expenditures shows how this works:

$GDP = C + I + G + NX$. GDP is the value of final goods and services produced in the economy.

On the right side are the sources of aggregate spending or demand:

(C)- Private consumption

(I)-Private investment

(G)-purchases of goods and services by the government (G),

(NX)- Exports minus imports

The equation shows that the government affect economic activity (GDP) by controlling G directly and influencing C, I, and NX indirectly, through changes in taxes and spending.

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