

Fiscal Stimuli and Consolidation¹

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I would like to begin with a quick review of the background to the fiscal stimuli that developed and emerging countries alike introduced with the stubbornness of the global financial crisis. Affected countries experienced severe economic contraction—reduction in, or negative, growth in GDP. This was generally accompanied by a decline in revenue/GDP and a rise in expenditure/GDP. The revival of economic activity anchored on quantitative easing did not materialize since the injected money, M , did not move to improve m , the collapsed money multipliers. Focus turned to fiscal stimuli through tax reductions and mainly current expenditure enhancements. But the size of the fiscal multiplier was not known either. Hence the dilemma as to whether the same fiscal stimuli would work to the same extent across countries. The already rising fiscal deficit/GDP was further exacerbated and public debt/GDP in some countries almost doubled. Stock markets and rating agencies did not appreciate the direction of these indicators and strategies had to be reformulated.

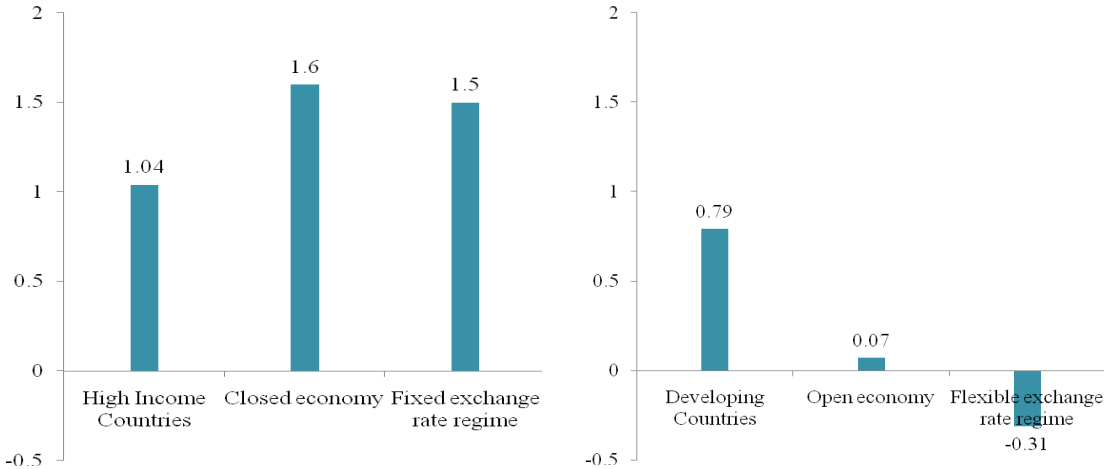
Strategies were refocused on fiscal consolidation though its pace was debated. One view was that fiscal loosening should continue; another was that fiscal policy should be tightened; a third view was to go somewhere in-between. Elections were won and lost on this issue. In the United Kingdom, for example, pre-election (March 2010) and post-election (June) positions viewed corrective policies very differently. Further, the final Spending Review (October) recomposed expenditure components in favor of investment over consumption, cutting back on untargeted direct consumption subsidies and reducing the length and pattern of unemployment coverage. Thus the choice made was one in favor of rapid consolidation through lower consumption, in contrast to the earlier demand driven (consumption plus investment) strategy. In India, in the latest February 2011 annual budget of the central government, fiscal consolidation is shown to be taking place through economic growth and from the expenditure side. Tax revenue will grow

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in real terms but not through any net discretionary measures. Thus, though both countries are taking fiscal consolidation measures, a single pattern does not emerge.

Professor Solow referred to fiscal multipliers. The difficulty with using them has been demonstrated convincingly by Ilzetzki, Mendoza and Vegh (2010). They show that the impact of fiscal stimulus depends on the particular characteristics of an economy. Thus larger fiscal multipliers result from higher income countries, less open economies, fixed rather than flexible exchange rate regimes, lower public debt, and higher investment than consumption (Figure 1) ⁱⁱ.

Figure 1. Estimated Values of Fiscal Multipliers



Source: Ilzetzki, Mendoza and Végh (2010).

The implication is that the same fiscal deficit/GDP will lead to different extent of stimuli in different countries posing a formidable challenge to using fiscal deficit/GDP as an indicator for reining in contagion globally.

Thus, to sum up to this point, Prof. Stiglitz mentioned that small and medium sized banks and credit channels didn't receive the benefit of stimuli as was the case of their borrowers. Indeed, there was also a psychological phenomenon or barrier for banks to lend reflecting the overall uncertain environment with subprime loans; in any event recognition of that problem led to refocusing on fiscal multipliers and then to the kind of dilemma with the usefulness of fiscal

multipliers. To assess what countries actually did, I examined India and the UK, two countries with relatively extreme economic indicators in terms of per-capita GDP and economic growth rates, and whether we could draw any lessons for fiscal coordination internationally.

As I said, 2010 for the UK was a very interesting year where you saw three different stances of fiscal consolidation. In March there was a pre-election budget, the general election took place in May, in June there was a post election budget and, finally in October, a spending review firmed up the final consolidation picture. The exercise was carried out for a period of projections up to 2014-15 and in some aspects up to 2015-16. The process: (1) increased taxes more; (2) maintained investment spending; (3) scaled back current spending considerably; (4) within current spending, cut back benefits (direct subsidies) much more than public services such as the National Health Service. Thus the right combination emerged between: (1) tax and expenditure; (2) investment and current spending; and (3) pure consumption and service oriented current spending (Table 1).

Table 1. UK: Selected Indicators

	2010	2012	2014
Real GDP Growth*			
March Budget 2010	1.25	3.5	3.25
June Budget 2010	1.2	2.8	2.7
October 2010 Spending Review ¹	1.8	2.6	2.8
Public Sector Net Borrowing (as % GDP)*			
March Budget 2010	11.1	6.8	4
June Budget 2010	10.1	5.5	2.1
October 2010 Spending Review ¹	10	5.6	1.9
Cyclically Adjusted Surplus on Current Borrowing (as % GDP)*			
March Budget 2010	-4.6	-2.5	-1.3
June Budget 2010	-4.8	-1.9	0.3
October 2010 Spending Review ¹	-4.7	-1.8	0.5
Net Public Debt (as % GDP)*			
March Budget 2010	63.6	73	74.9
June Budget 2010	61.9	69.8	69.4
October 2010 Spending Review ¹	60.8	69.1	68.8
Total Tightening (£ Billion), of which :	72.4	112.6	110.3
Spending /Tax (ratio)	70/30	74/26	73/27

Current/ Investment Spending (ratio)	66/34	77/23	79/21
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Notes:

- 1) Economic data taken from Office of Budget Responsibility's Autumn "Economic and Fiscal Outlook".
- 2) Figure given for tax years (i.e. 2009=2009/10).

This new fiscal policy mix that relied more on spending cuts than on tax increase was along the lines of the findings of academicians such as Alesina and Ardagna (2009) who found that fiscal adjustments mostly on the spending side are better suited for not creating large recessions on impact. Further, the projections for the rise in public debt/GDP were scaled back by almost five percentage points by 2014-15. Given that pre-election campaigning did reveal the overall direction of fiscal tightening that the Conservatives planned as post-election policy, and that they nevertheless won, appear to justify another finding by Alesina, Perotti and Taveres (1998) that, cross-country, fiscal rectitude was rewarded by voters. I would, therefore, say that governments by themselves, when pushed to a corner, would tend to react and take appropriate fiscal measures. Indeed this happened in the UK despite a heavy *quid pro quo* that comprised a considerable reduction in the projections for the economic growth trajectory.ⁱⁱⁱ And, since the nominal fiscal tightening of the post-election government is larger than that of the pre-election one, the fiscal consolidation turns out to be even more stringent in terms of (the lowered) GDP.

In India too, in the last central budget which was presented in parliament on February 28, fiscal consolidation of 1½ percent of GDP has come from the expenditure side (Table 2). Of this, ½ percent is from cutbacks in subsidies alone (Table 2).

Table 2. India: Fiscal Consolidation

	2008-09	2009-10	2010-11	2011-12 Budget
	(Δ % to GDP)			
1) Tax Revenue (net to centre)	-0.87	-0.97	0.19	0.24
2) Non-Tax Revenue	-0.32	0.04	1.02	-1.40
3) Capital Receipts**	-0.76	0.39	-0.10	0.21
4) Total Consolidation of Revenue Side	-1.95	-0.55	1.10	-0.94

	(Δ % to GDP)×-1			
5) Non-Plan Expenditure	-0.72	-0.10	0.58	1.34
6) Plan Expenditure	-0.82	0.30	-0.38	0.10
7) Total Consolidation of Expenditure	-1.54	0.19	0.20	1.44
8) Fiscal Deficit (7+4)	-3.5	-0.4	1.3	0.5
9). Primary Deficit	-3.5	2.9	1.1	0.4

Notes:

1) + Tighten / - Loosen

**2) Does not include receipts in respect of Market Stabilization Scheme and excludes Borrowings and other Liabilities

As Ms. Indrawati just said, these moments offer an excellent opportunity to correct structural deficiencies in expenditure. Just as the UK recomposed its expenditure, what India seems to be doing is, post-crisis, scale back distortionary subsidies on fertilizers, food and petroleum while, during the crisis, it loosened its fiscal stance including on subsidies (Table 3). Announcements in cutbacks in subsidies have not affected elections adversely so far.

Table 3. India: Tightening of Subsidies

	2008-09	2009-10	2010-11	2011-12 Budget
	(Δ% to GDP)×-1			
Subsidies, of which:	-0.92	0.17	0.07	0.49
Fertiliser	-0.76	0.44	0.24	0.14
Food	-0.15	-0.11	0.12	0.09
Petroleum	0.01	-0.18	-0.26	0.22
Interest	-0.01	0.02	-0.03	-0.01
Other	-0.01	-0.01	0.00	0.04

Notes:

1) + Tighten / - Loosen

It is true that there was no net revenue generation through discretionary tax measures in the budget, but India is anticipating two major structural tax reforms in both income and consumption taxes prior to which the government appears not to be taking major discretionary action. Here the government will be tested strongly, for the anticipation that the tax structure will be rationalized and that uncertainties that are embedded in the structure will be reduced,

is widespread. In sum, when tax and expenditure are consolidated in the fiscal sector, the numbers reveal a clear pattern of relaxation during the crisis followed by quick tightening post-crisis. Thus, on the whole, India has selected a counter-cyclical fiscal path though not a mirror image of the policy mix selected by the UK.

I would conclude, therefore, that stakeholders in society need massive fiscal stimuli only extraordinarily. They have become mature and trust rational fiscal policies that do not generate inequity through untargeted subsidies or burden them through generations. Voters will reward sensible fiscal policy. Further, since the size of fiscal multipliers vary across countries reflecting their particular characteristics, fiscal deficit/GDP of each country will produce a different stimulus. Thus a country with a low fiscal multiplier would need to be accommodated with a higher fiscal deficit before any international action is triggered, compared with one that has a higher fiscal multiplier. It is therefore not feasible to fix a single fiscal deficit/GDP as a trigger for an internationally driven domestic policy change.

Instead, the International Monetary Fund, with its recently enhanced resources, should seek the sanction to take stronger action in contagion countries based on that country's own fiscal performance in a historical or time series perspective rather than on the basis of a cross-country perspective. Flexibility for the Fund in that intervention should be safeguarded and its strength buttressed with stronger non-static analysis in the Fund's regular financial programming framework.

Once it is understood that, for containing or averting global financial contagion, it is best to deemphasize traditional indicators and triggers spanning every sector—real, monetary, fiscal and external—that are generally known, it should be possible to develop meaningful ones from the viewpoint to contain financial contagion. A few traditional indicators based on current account imbalances, the size and movement of foreign exchange reserves, external—in particular short term—debt would continue to have to be used. But the challenge remains to design indicators targeting financial instability more directly. These would be based on, among others, potential flight capital, volatility of capital flows and stock markets, and interest rate

spreads that tend to precede or are associated with financial crises. It is not as though empirical evidence does not exist. What is needed is the resolve of developed economies and the leadership from multilateral institutions, in particular the Fund, that should push for such sharpened indicators rather than broad ones.

Q& A session

Time does not allow me to take all the comments but only selectively. David Romer's point that voters are generally not quite aware: frankly I would not say that. I think voters *are* aware. Rather, all forms of government, in the ultimate analysis, are plutocracies that tend to move away from rational voter preferences over time. It is governments that actually make the mistake of either carrying out populist, unstable policies on the expenditure side or the tax side. In democracies, voters can ultimately vote them out. Therefore, increasingly, mature policy changes that governments eventually undertake have to reflect overall voter choices.

On the fact of financial sector excesses, corrective steps have to comprise structural policies. If we go back to the Great Depression of the United States and if we agree that the establishment of FDIC, the Federal Deposit Insurance Corporation, was the structural reform that finally unhinged the lock that brought back savers' confidence and assisted the US to get out of the Depression, then we are still looking for some meaningful structural changes in today's crisis in the international—and US—financial context to meaningfully deliver the international economy from the current crisis. This would comprise global financial sector regulation if not supervision, and not fiscal or other such triggers.

But what I am saying is that, that doesn't mean that, therefore, we should go easy on fiscal policy. I think that, while there are good fiscal indicators, they are not easily universalizable; therefore individual countries should address fiscal problems themselves. And, if needed, the Fund should assist in designing strong programs for them.

On the question of political consensus, my reading of the UK is that a coalition could have been formed by different combinations of political parties. But post election, while the exact policy

mix would be different with each, overall they would reflect fiscal sobriety since that is what the voter voted for. In any event, the current policy stance does reflect that of the majority.

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ⁱⁱ The fact that generally high income countries are also open economies with flexible exchange rates does impart a bit of anomaly to the findings though that by itself does not detract from the overall argument that fiscal multipliers are likely to be very different across economies.

ⁱⁱ The new projections were much closer to the average of the projections made by the main independent projectors.

References

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