

FISCAL STIMULII AND CONSOLIDATION: RECENT EXAMPLES

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Financial Crisis and Fiscal Consolidation

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- * Affected countries experienced severe economic contraction – reduction in or negative growth in GDP
- * Accompanied by decline in revenue/GDP and rise in expenditure/GDP
- * Revival of economic activity anchored on quantitative easing which did not work fast enough since the injected money sat with collapsed money multipliers
- * Focus then 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 the role of fiscal policy in crises
- * 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 these indicators and strategies had to be reformulated

Pace of Fiscal Consolidation

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- * Strategies were refocused on fiscal consolidation and 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 UK for example, pre-election (March 2010) and post-election (June) positions viewed corrective policies very differently. Further, the final Spending Review (October) further 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 fast fiscal consolidation through lower consumption, over the earlier demand driven (consumption plus investment) strategy
- * In India in the last February 2011 central Budget, the net tax measures yield a negative amount. Fiscal consolidation will be achieved through economic growth
- * Thus within same country or across countries, no single model emerges

Size of the Fiscal Multipliers

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Ilzetzki, Mendoza & Végh propose that the impact of fiscal stimulus depends on particular characteristics of an economy.

Larger fiscal multipliers result from:

- Higher income countries
- Less open economies
- Fixed rather than flexible exchange rate regimes
- Lower public debt
- Higher investment than consumption

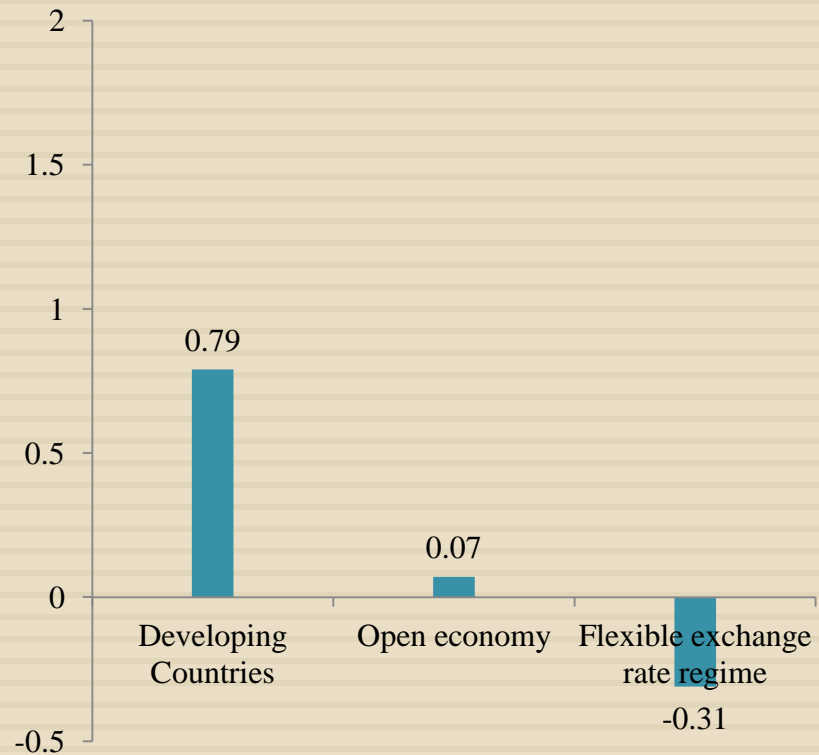
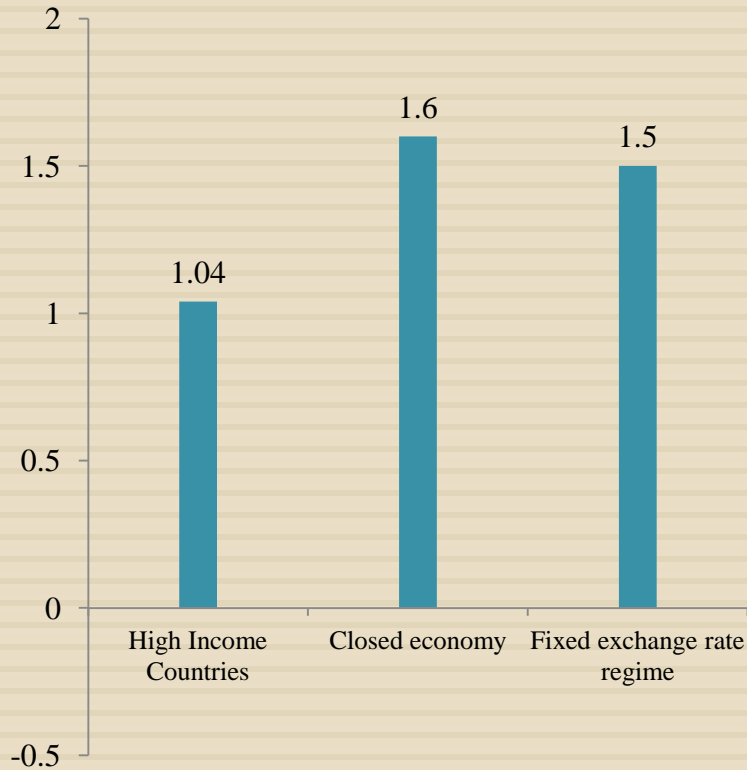
If true, cross-country ideal fiscal packages must be different during crises

Reference

Ethan Ilzetzki & Enrique G. Mendoza & Carlos A. Végh, 2010. "How Big (Small?) are Fiscal Multipliers?," NBER Working Papers 16479,

Estimated Values of Fiscal Multipliers

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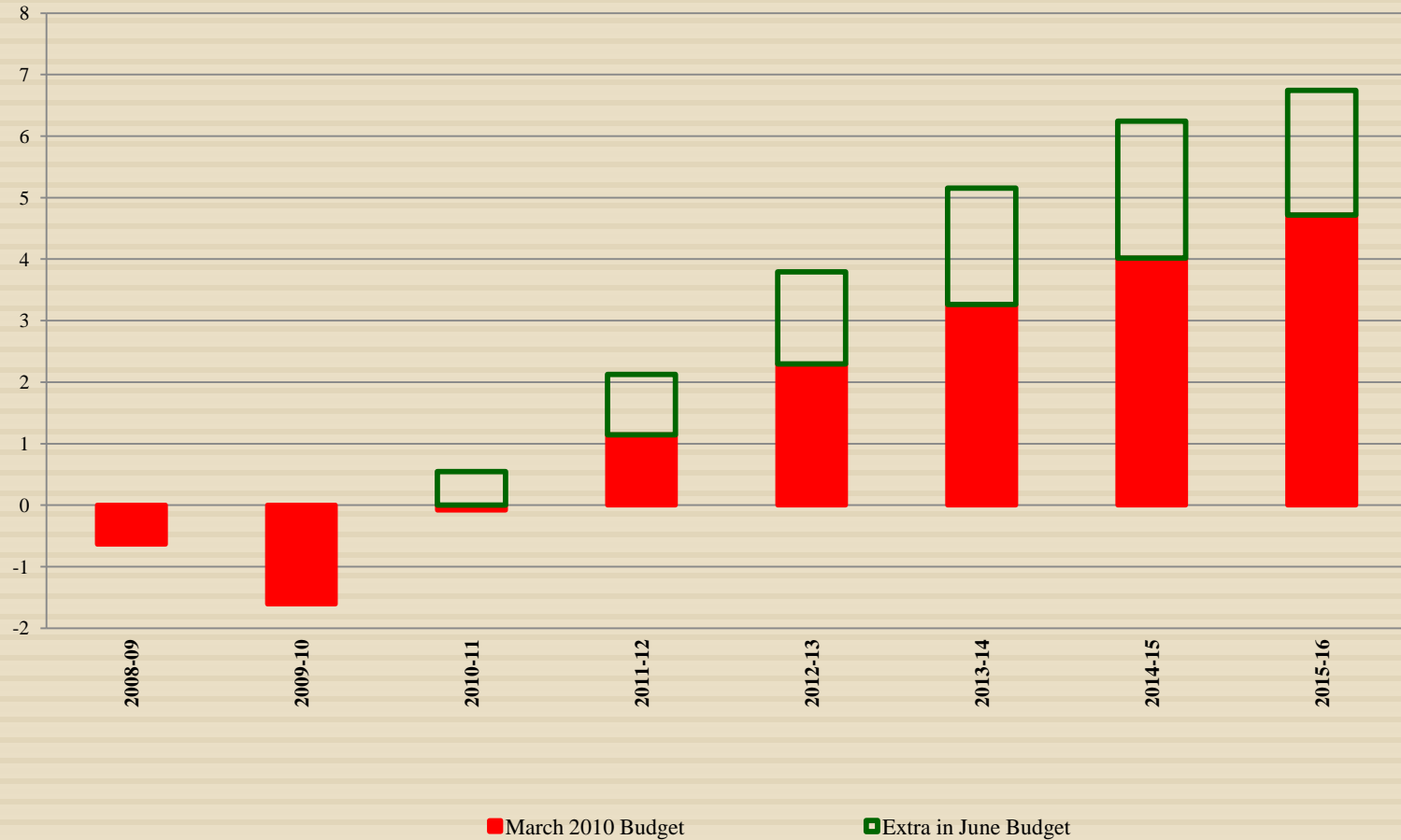


Reference

Ethan Ilzetzki & Enrique G. Mendoza & Carlos A. Végh, 2010. "How Big (Small?) are Fiscal Multipliers?," NBER Working Papers 16479,

UK Fiscal Consolidation Projections

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Source: Institute of Fiscal Studies (2010)

UK Change in Fiscal Strategy

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- Alesina and Ardagna (2009) 1/ found fiscal adjustments mostly on the spending side are better suited for not creating large recessions on impact.
- Post-election UK opted for this (Slide 6, Figure in shows *additional* tightening). Final calibration occurred in October Spending Review. So what happened in June and October in two steps:
 - (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 (NHS)
 - Thus the right combination emerged between: (1) tax and expenditure; (2) between investment and current spending; (3) between pure consumption, and service oriented current spending; (4) new mix relied more on spending cuts than tax increase (Slide 8, Table Rows 9 and 10); (5) public debt/GDP improved faster by almost 5 percentage (Row 11)
- 1/ “Large Changes in Fiscal Policy: Taxes versus Spending,” NBER WP 15438.

UK Composition of Tightening: Projections for 2014-15

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£ billion	March 2010 Budget	June 2010 Budget	October 2010 Spending Review
1. Tax	21.5	29.8	29.8
2. Spending	50.9	82.8	80.5
3. Investment Spending	17.2	19.3	17.0
4. Current Spending	33.7	63.5	63.5
<i>of which:</i>			
5. Debt Interest	7.0	10.0	10.0
6. Benefits	-0.3	10.7	17.7
7. Public Services	27.0	42.8	35.7
8. Total Tightening	72.4	112.6	110.3
9. % Spending	70.0	74.0	73.0
10. % Tax	30.0	26.0	27.0
11. Forecast Net Public Debt as % GDP in 2013/14	74.5	70.3	69.7

Source: Calculations based on Institute of Fiscal Studies (2010)

UK Breakdown of Tightening in 2014-15

(as projected in March, June and October 2010)

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- The austerity program table explains for 2014-15 how the tightening—tax increase and expenditure reduction—breaks down in March, June and October budgets:
- (1) Tax increase shot up between March and June Budgets (Row 1) while expenditure reduction was more severe than tax increase (Slide 10, Row 2). Cut in investment spending was a bit deeper in June than March but the cut was pulled back and investment spending was restored in October (Slide 10, Row 3)
- Current spending cutback almost doubled between the two governments (Slide 10, Row 4). Direct benefits (consumption subsidies and work incentives) that were protected in March were reduced considerably in June (even more than their tax increase) and the benefits cutback was further scaled back in October. Thus new government reallocated cuts in current spending between June and October, making them deeper for direct subsidies and less so for NHS.

UK Selected Macro Indicators

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	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

* Figure given for tax years (i.e. 2009=2009/10)

1. Economic data taken from OBR's Autumn "Economic and Fiscal Outlook"

UK Conclusions from Macro Indicators

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- First, there is considerable reduction in the trajectory of GDP growth between March and June budgets; series now closer to average of independent projectors
- Second, projections of public sector net borrowing / GDP also declined from March to June through October
- Third, a comparable change occurred in the cyclically adjusted current fiscal surplus—the March figures had projected a deficit even for 2014
- Fourth, translated into net public debt, the increase in the series in terms of GDP became less pronounced between March and June Budgets, and further so in October
- The quid pro quo was that the much deeper fiscal consolidation would be achieved with a lower economic growth—and therefore income path—based on more realistic projections

India Fiscal Strategy through Crisis

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- India's fiscal strategy through and post crisis reveals a relaxation in tax and expenditure effort during crisis followed by relaxation from 2010-11 (Slide 14, Rows 1 and 7)
- The total consolidation picture is dependent somewhat on serendipity as non-tax revenue growth flip-flopped due to temporary gains from spectrum sales (Slide 14, Row 2) and disinvestment receipts
- In expenditure, efforts towards counter-cyclical policy in non-Plan (close to current) expenditure has been successful (Slide 14, Row 5); but Plan expenditure maintenance has been unstable (Slide 14, Row 6)
- Post-crisis, 2010-11 and 2011-12, fiscal consolidation came mainly from expenditure side rather than revenue (ignoring the spectrum component) similar to the post election UK strategy

India Fiscal Consolidation

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	2008-09	2009-2010	2010-2011	2011-2012 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 Side	-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

India Tax and Subsidy Tightening

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- Post-crisis, the tax buoyancy is coming from growth rather than measures (in Budget 2011-12, discretionary measures are slightly negative. During the up-cycle, this appears to be pro-cyclical and might have been addressed
- Components of tax effort or buoyancy are widely different year by year indicating varying tax policies through time (Slide 16, Row 3 customs in 2010-11 and Row 1 corporate tax in 2011-12)
- In recent years, subsidies are being tightened (Slide 17) in all components, including the large ones: fertilizer, food and petroleum
- On the whole, the direction of fiscal consolidation has been correct

India Tax Effort

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	2008-09	2009-10	2010-11	2011-12 Budget
	(% to GDP)			
Δ in Tax Revenue	-0.87	-0.97	0.19	0.24
Composition of the Δ in Gross Tax Revenue				
1) Corporation Tax	-4.4	-6.6	5.7	62.52
2) Taxes on Income other than Corporation Tax	-15.1	-2.4	-15.7	8.9
3) Customs	-28.4	-39.5	88.3	4.1
4) Union Excise Duties	-50.7	-28.5	37.4	20.0
5) Service Tax	6.0	-15.3	-2.4	8.1
6) Wealth Tax	0.0	0.1	-0.1	0.0
7) Other Taxes and Duties	-7.4	-7.5	-13.3	-3.0
8) Taxes of Union Territories	0.0	-0.2	-0.1	-0.6
Total	-100	-100	100	100

Note: + Tighten / - Loosen

India Tightening of Subsidies

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

Note: + Tighten / - Loosen

Concluding Remarks

- In an early paper at Brookings, Alesina, Perotti and Tavares (1998) found cross-country that fiscal rectitude was rewarded by voters. UK has proved a case in point. The new coalition's more austere fiscal stance won the voters' confidence. A challenge appeared later when the inheritors of an almost doubled public debt/GDP were told to anticipate an almost threefold increase in university tuition
- India has revealed that it has been following counter-cyclical fiscal policy through, and post, crisis. Announcements of cutbacks in subsidies have not affected election outcomes across states so far; and, though net revenue yielding discretionary measures have by and large been absent, anticipation of tax reform—for rationalization of the tax structure and reduction in its uncertainties, even if such reform implies more revenue—is widespread
- Stakeholders in society need fiscal support only extraordinarily. They have become mature and trust rational fiscal policies that do not generate inequity through untargeted subsidies or burden them through time. It is better to go for fast fiscal consolidation as early as possible.

Annex UK GDP series

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	Gross domestic product	
Subject Descriptor	constant prices	current prices
Units	National currency	
Scale	Billions	
2005	1,292.34	1,254.06
2006	1,328.36	1,328.36
2007	1,364.03	1,404.85
2008	1,363.14	1,445.58
2009	1,296.39	1,392.71
2010	1,318.46	1,464.72

Source: IMF

Note: In 2010, GBP/USD is 1.55.

Annex India GDP series

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	Gross domestic product	
Subject Descriptor	constant prices	current prices
Units	National currency	
Scale	Billion	
2005-06	36925	35443
2006-07	42937	38730
2007-08	49864	42532
2008-09	55826	44630
2009-10	65503	48693
2010-11	78779	53426

Source: CSO, India

Note: In 2010-11, GDP at current prices is equivalent to US\$ 1727 billion and equivalent to £ 1112 billion.