BACK TO BASICS

What Is Fiscal Policy?

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FISCAL policy is the use of government spending and taxation to influence the economy. Governments typically use fiscal policy to promote strong and sustainable growth and reduce poverty. The role and objectives of fiscal policy have gained prominence in the current crisis as governments have stepped in to support financial systems, jump-start growth, and mitigate the impact of the crisis on vulnerable groups. In the communiqué following their London summit in April, leaders of the Group of Twenty industrial and emerging market countries stated that they are undertaking "unprecedented and concerted fiscal expansion." What do they mean by fiscal expansion? And, more generally, how can fiscal tools provide a boost to the world economy?

Historically, the prominence of fiscal policy as a policy tool has waxed and waned. Before 1930, an approach of limited government, or laissez-faire, prevailed. With the stock market crash and the Great Depression, policymakers pushed for governments to play a more proactive role. More recently, countries scaled back the size and function of government, with markets taking on an enhanced role in the allocation of goods and services. Now, with the financial crisis in full swing, a more active fiscal policy is back in favor.

How does fiscal policy work?

When policymakers seek to influence the economy, they have two main tools at their disposal—monetary policy and fiscal policy. Central banks indirectly target activity by influencing the money supply through adjustments to interest rates, bank reserve requirements, and the sale of government securities and foreign exchange; governments influence the economy by changing the level and types of taxes, the extent and composition of spending, and the degree and form of borrowing.

Governments directly and indirectly influence the way resources are used in the economy. The basic equation of national income accounting helps show how this happens:

$$GDP = C + I + G + NX.$$

On the left side is gross domestic product (GDP)—the value of all final goods and services produced in the economy (see "Back to Basics," *F&D*, December 2008). On the right side are the sources of aggregate spending or demand—private consumption (C), private investment (I), purchases of goods and services by the government (G), and exports minus imports (net exports, NX). This equation makes it evident that governments affect economic activity (GDP), controlling G directly and influencing C, I, and NX indirectly, through changes in taxes, transfers, and spending. Fiscal policy that increases aggregate demand directly through an increase in government spending is typically called expansionary or "loose." By contrast, fiscal policy is often considered contractionary or "tight" if it reduces demand via lower spending.

Besides providing goods and services, fiscal policy objectives vary. In the short term, governments may focus on macroeconomic *stabilization*—for example, stimulating an ailing economy, combating rising inflation, or helping reduce external vulnerabilities. In the longer term, the aim may be to foster sustainable growth or reduce poverty with actions on the *supply side* to improve infrastructure or education. Although these objectives are broadly shared across countries, their relative importance differs depending on country circumstances. In the short term, priorities may reflect the business cycle or response to a natural disaster—in the longer term, the drivers can be development levels, demographics, or resource endowments. The desire to reduce poverty might lead a low-income country to tilt spending toward primary health care, whereas in an advanced economy, pension reforms might target looming long-term costs related to an aging population. In an oil-producing country, fiscal policy might aim to moderate procyclical spending—moderating both bursts when oil prices rise and painful cuts when they drop.

Response to the crisis

The crisis has had a negative impact on economies around the globe, with financial sector difficulties and flagging confidence hitting private consumption, investment, and international trade (recall the national income accounting equation). Governments have responded by aiming to boost activity through two channels: automatic stabilizers and fiscal stimulus—that is, new discretionary spending or tax cuts. Stabilizers go into effect as tax revenues and expenditure levels change and do not depend on specific actions but operate in relation to the business cycle. For instance, as output slows or falls, the amount of taxes collected declines because corporate profits and taxpayers' incomes fall. Unemployment benefits and other social spending are also designed to rise during a downturn. These cyclical changes make fiscal policy automatically expansionary during downturns and contractionary during upturns.

Automatic stabilizers are linked to the size of the government, and tend to be larger in advanced economies. Where

stabilizers are larger, there may be less need for stimulus—tax cuts, subsidies, or public works programs—since both approaches help to soften the effects of a downturn. Indeed, in the current crisis, countries with larger stabilizers have tended to resort less to discretionary measures. In addition, although discretionary measures can be tailored to stabilization needs, automatic stabilizers are not subject to implementation lags (for example, design, approval, and implementation of new road projects), and their impacts are automatically withdrawn as conditions improve. Stimulus may be difficult to design and implement effectively and difficult to reverse when conditions pick up. In many low-income and emerging market countries, however, institutional limitations and narrow tax bases mean stabilizers are relatively weak. Even in countries with larger stabilizers, there may be a pressing need to compensate for the loss of economic activity and compelling reasons to target the government's crisis response to those most directly in need.

The exact response ultimately depends on the fiscal space a government has available for new spending initiatives or tax cuts—that is, its access to additional financing at a reasonable cost or its ability to reprioritize its existing expenditures. Some governments have not been in a position to respond with stimulus, because their potential creditors believe additional spending and borrowing would put too much pressure on inflation, foreign exchange reserves, or the exchange rate—or take too many resources from the local private sector (also known as crowding out), delaying recovery. For other governments, more severe financing constraints have necessitated spending cuts as revenues decline (stabilizers functioning). In countries with high inflation or external current account deficits, fiscal stimulus is likely to be ineffective, and even undesirable.

Fine-tuning the response

The size, timing, composition, and duration of stimulus matter. Policymakers generally aim to tailor the size of stimulus measures to their estimates of the size of the output gap—the difference between expected output and what output would be if the economy were functioning at full capacity. A measure of the effectiveness of the stimulus—or, more precisely, its translation in terms of output (also known as the multiplier)—is also needed. Multipliers tend to be larger if there is less leakage (for example, only a small part of the stimulus is saved or spent on imports), monetary conditions are accommodative (interest rates do not rise as a consequence of the fiscal expansion), and the country's fiscal position after the stimulus is viewed as sustainable. Multipliers can be small or even negative if the expansion raises concerns about future sustainability, in which case the private sector would likely counteract government intervention by increasing savings or even moving money offshore, rather than investing or consuming. Multipliers also tend to be higher for spending measures than for tax cuts or transfers and for larger countries (in both cases, because of fewer leakages). As for timing, it often takes time to implement spending measures, and once in place they may no longer be needed. However, if the downturn is expected to be prolonged (as in the current crisis), concerns over lags may be less pressing. For all these reasons, stimulus measures should be timely, targeted, and temporary—quickly reversed once conditions improve.

Similarly, the responsiveness and scope of stabilizers can be enhanced; for instance, by a more progressive tax system—taxing high-income households at a higher rate than lower-income households. Transfer payments can also be explicitly linked to economic conditions (for instance, unemployment rates or other labor market triggers). In some countries, fiscal rules aim to limit the growth of spending during boom times, when revenue growth—particularly from natural resources—is high. Elsewhere, formal review or expiration ("sunset") mechanisms for programs help ensure that new initiatives do not outlive their initial purpose. Finally, medium-term frameworks with comprehensive coverage and assessment of revenues, expenditures, assets and liabilities, and risks help improve policymaking over the business cycle.

Big deficits and rising public debt

Fiscal deficits and public debt ratios have expanded sharply in many countries with the fiscal response of the crisis. Support and guarantees to financial and industrial sectors have added to concerns. Many countries can afford to run moderate fiscal deficits for extended periods, with domestic and international financial markets and international and bilateral partners convinced of their ability to meet present and future obligations. Deficits that grow too large and linger too long may, however, undermine that confidence. Aware of these risks in the present crisis, the IMF is calling on governments to establish a four-pronged fiscal policy strategy to help ensure solvency: stimulus should not have permanent effects on deficits; medium-term frameworks should include commitment to fiscal correction once conditions improve; structural reforms should be identified and implemented to enhance growth; and countries facing medium- and long-term demographic pressures should firmly commit to clear strategies for health care and pension reform. ■

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Suggestions for further reading:

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