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5
Fiscal Stimuli and Consolidation

Parthasarathi Shome

Developed and emerging countries alike introduced fiscal stimuli in response to the global financial crisis of 2008. Affected countries experienced severe economic contraction—reduction in or negative growth in gross domestic product. This was generally accompanied by a decline in revenue per GDP and a rise in expenditures per GDP. The revival of economic activity anchored on quantitative easing did not materialize because the injected money, M, did not move to improve m, the collapsed money multipliers. The focus turned to fiscal stimuli through tax reductions and mainly current expenditure enhancements. But the size of the fiscal multiplier was not known either. The dilemma was whether the same fiscal stimuli would work to the same extent across countries. The already rising fiscal deficit per GDP was further exacerbated, and public debt per 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, although its pace was debated. One view was that fiscal loosening should continue, another was that fiscal policy should be tightened, and a third view was to go somewhere in between. Elections were won and lost on this issue. In the United Kingdom, for example, preelection (March 2010) and postelection (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's

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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 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.

The difficulty with using fiscal multipliers has been demonstrated convincingly by Ethan Ilzetzki, Enrique G. Mendoza, and Carlos A. Végh (2010). They show that the effect of fiscal stimulus depends on the 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, and higher investment than consumption (figure 5.1).[1] The implication is that the same fiscal deficit per GDP will lead to different stimuli in different countries, which poses a formidable challenge to using fiscal deficit per GDP as an indicator for reining in contagion globally.

Small and medium-sized banks and credit channels (and their borrowers) did not receive the benefit of stimuli. There was also a psychological

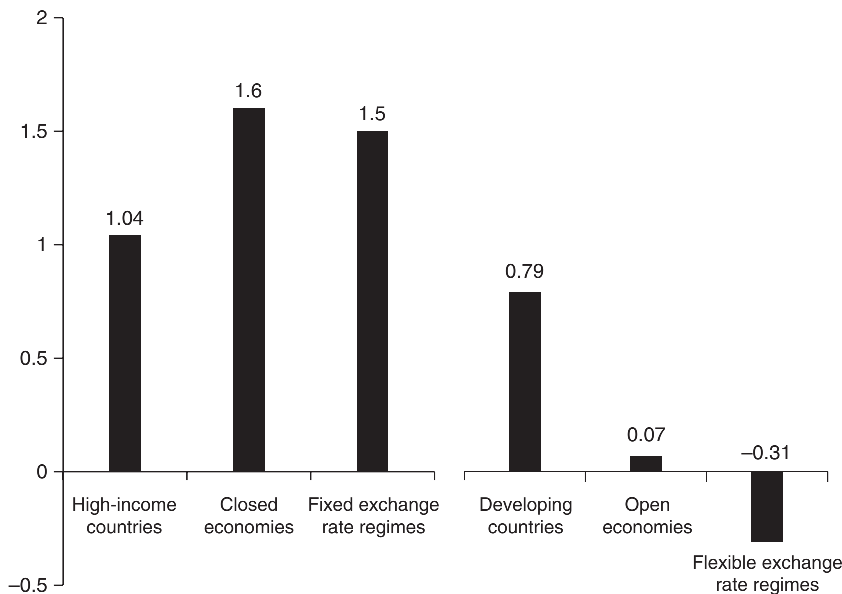

Figure 5.1
Estimated values of fiscal multipliers. *Source:* Ilzetzki, Mendoza, and Végh (2010).

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phenomenon or barrier for banks to lend, reflecting the overall uncertain environment with subprime loans. In any event, recognition of that problem led to a refocusing on fiscal multipliers, and then to a kind of dilemma with the usefulness of fiscal multipliers. To assess what countries actually did, I examined India and the United Kingdom, two countries with relatively extreme economic indicators in terms of per-capita GDP and economic growth rates, to see if any lessons could be drawn for fiscal coordination internationally.

In 2010, the United Kingdom had a preelection budget in March, the general election took place in May, there was a postelection budget in June, and a spending review firmed up the final consolidation picture in October. The exercise was carried out for a period of projections up to 2014–2015 and in some aspects up to 2015–2016. The process (1) increased taxes, (2) maintained investment spending, (3) scaled back current spending considerably, and (4) within current spending, cut back benefits (direct subsidies) much more than public services such as the National Health Service. The right combination emerged among (1) tax and expenditure, (2) investment and current spending, and (3) pure consumption and service-oriented current spending (table 5.1).

This new fiscal policy mix relied more on spending cuts than on tax increases and was in line with the findings of academicians such as Alberto Alesina and Silvia Ardagna (2009), who found that fiscal adjustments mostly on the spending side are better suited for avoiding large recessions. Further, the projections for the rise in public debt per GDP were scaled back by almost five percentage points by 2014–2015. Preelection campaigning revealed the overall direction of fiscal tightening that the Conservatives planned as postelection policy, and they nevertheless won. This appeared to justify a finding by Alberto Alesina, Roberto Perotti, and José Taveres (1998) that fiscal rectitude was rewarded by voters. In general, it appears that governments, when backed into a corner, tend to take appropriate fiscal measures. This happened in the United Kingdom, despite a considerable reduction in projections for the economic growth trajectory.[2] In addition, because the nominal fiscal tightening of the postelection government is larger than that of the preelection one, the fiscal consolidation turns out to be even more stringent in terms of (the lowered) GDP.

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Table 5.1
United Kingdom: Selected indicators, 2010 to 2014

	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[a]	1.8	2.6	2.8
*Public-sector net borrowing (as percentage of GDP)**			
March budget 2010	11.1	6.8	4
June budget 2010	10.1	5.5	2.1
October 2010 spending review[a]	10	5.6	1.9
*Cyclically adjusted surplus on current borrowing (as percentage of GDP)**			
March budget 2010	-4.6	-2.5	-1.3
June budget 2010	-4.8	-1.9	0.3
October 2010 spending review[a]	-4.7	-1.8	0.5
*Net public debt (as percentage of GDP)**			
March budget 2010	63.6	73	74.9
June budget 2010	61.9	69.8	69.4
October 2010 spending review[a]	60.8	69.1	68.8
Total tightening (billions of pounds), of which	*72.4*	*112.6*	*110.3*
Spending per tax (ratio)	70/30	74/26	73/27
Current per investment spending (ratio)	66/34	77/23	79/21

Notes: a. Economic data taken from Office of Budget Responsibility, "Economic and Fiscal Outlook" (Autumn 2010); * Figure given for tax years (that is, 2010 = 2010/11).

In India's 2011/12 central budget, which was presented in Parliament on February 28, 2011, fiscal consolidation of 1½ percent of GDP has come from the expenditure side (table 5.2). Of this, ½ percent is from cutbacks in subsidies alone (see table 5.2). These moments offer an excellent opportunity to correct structural deficiencies in expenditure. Just as the United Kingdom recomposed its expenditure, what India seems to be doing postcrisis is scaling back distortionary subsidies on fertilizers, food, and petroleum, while during the crisis it loosened its fiscal stance, including on subsidies (table 5.3). Announcements of cutbacks in subsidies have not affected elections adversely so far.

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

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Table 5.2
India: Fiscal consolidation, 2008 to 2012

	2008–2009	2009–2010	2010–2011	2011–2012 Budget
	(Δ% to GDP)			
1. Tax revenue (net to center)	-0.87	-0.97	0.19	0.24
2. Nontax revenue	-0.32	0.04	1.02	-1.40
3. Capital receipts[a]	-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. Nonplan 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: + indicates tightening; - indicates loosening. a. Does not include receipts in respect of market stabilization scheme and excludes borrowings and other liabilities.

Table 5.3
India: Tightening of subsidies

	2008–2009	2009–2010	2010–2011	2011–2012 Budget
	(Δ% to GDP) × -1			
Subsidies, of which	-0.92	0.17	0.07	0.49
Fertilizer	-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

Note: + indicates tightening; - indicates loosening.

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government appears not to be taking major discretionary action. There is widespread anticipation that the tax structure will be rationalized and that uncertainties that are embedded in the structure will be reduced. 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 postcrisis. On the whole, India has selected a countercyclical fiscal path, although it is not a mirror image of the policy mix selected by the United Kingdom.

I 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 varies across countries, reflecting their particular characteristics, fiscal deficit per 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 per 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 each 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 nonstatic analysis in the Fund's regular financial programming framework.

When it is understood that, for containing or averting global financial contagion, it is best to deemphasize traditional indicators and triggers spanning real, monetary, fiscal, and external sectors, it should be possible to develop meaningful ones to contain financial contagion. A few traditional indicators—based on current-account imbalances, the size and movement of foreign-exchange reserves, and external (particularly 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

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precede or are associated with financial crises. Empirical evidence does exist. Basel II was not successful, and Basel III has moved part of the way (Shome and Rathinam 2010). What is needed is the resolve of developed economies and the leadership from multilateral institutions, particularly the Fund, which should push for such sharpened indicators rather than broad ones.

Notes

1. The fact that high-income countries generally are also open economies with flexible exchange rates does not detract from the overall argument that fiscal multipliers are likely to be different across economies.

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

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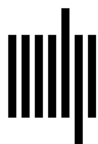

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