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Review Paper

Perspectives Fiscal Policy as a Stabilization Tool: Discretionary and Non Discretionary Policies

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ABSTRACT

Global financial crisis of 2008 and the Covid 19 led slowdown have brought Keynesian fiscal stabilization policies back to the forefront of all academic debates. But what the world is experiencing should be treated as an exceptional situation that should not be used to advance the case to fine-tune the economy every time using discretionary fiscal measures. The pre-crisis broad macroeconomic consensus still holds, and stabilization should first be left to monetary policy. On the fiscal front government should rely more on rule-based inbuilt stabilizers for short-term management of cyclical fluctuations in case of demand shocks and long-run fiscal policy should focus more on growth and developing enabling factors to attract more investment. Fiscal stabilizers on the expenditure side should be strengthened to provide an adequate safety net to economically vulnerable sections of the society.

Highlights

- Fiscal policy: discretionary and non-discretionary, can be used to tackle the economic shocks
- During period of high macroeconomic volatility, M.N.R.E.G.A. can help in smoothening of consumption levels of rural poor
- Buoyancy estimates of custom duty show that they offset the total stabilizing effect of government revenues.

Keywords: Fiscal Policy, automatic stabilisers, discretionary fiscal policy

Keynes in the General theory of Income and Employment (1936) argued that an increase in government expenditure is an effective stabilization tool when an economy is operating below full employment level. The standard Keynesian model of demand higher government expenditure would lead to higher levels of output and employment because of the multiplier effect. The focus of empirical research during the eighties and nineties was primarily on monetary policy. However, the situation changed with the Global Financial Crisis of 2008, leading focus shifting to research in the stabilization role of fiscal policy. The use of discretionary fiscal policy in the U.S.A. as a stabilization tool in the post 9/11 attacks recession and the formation of the European Monetary Union also played an important role in the shift. Blanchard and Perotti (1999; 2002), Perotti (2002; 2005), Fatás and Mihov (1999; 2001), Fatas (2003), and Mountford and Uhlig (2002) analyzed fiscal policy using V.A.R. methodology. Since then, a similar methodology has been used to study the impact of fiscal policy for different countries.

The nature of the business cycle in India has changed with the increasing integration of the Indian economy with the rest of the world in the post reforms period. The current situation has provided a glimpse of what can be a regular feature

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in coming decades.' But for emerging nations like India, adequate fiscal space to manouvere their public finances for stabilization is unfortunately limited owing to their huge debt liabilities with India's debt to G.D.P. ratio 89.3%. in 2 To tackle the problem, India will have to efficiently use both discretionary and non-discretionary fiscal policies, especially when monetary policy is ineffective.020.

Analysis of stabilization role of fiscal policy requires information on:

- Cyclical structure of fiscal policy: whether the policy has been pro or countercyclical.
- Potential of discretionary fiscal policy to influence demand.

Size of automatic stabilizers[1]

Detailed analysis of each of these factors for the Indian economy is out of scope of this paper. An attempt has been made to understand the discretionary and non discretionary component of fiscal policy in stabilizing economic activity. The Paper is organized into five sections. Next section discusses the merits and demerits of discretionary and non-discretionary components of fiscal policy. Third section of the paper briefly summarises some of the current literature and in the fourth section attempt to give a rough idea of the size of automatic fiscal stabilizers for the Indian economy followed by the conclusion.

Business cycle and fiscal policy

A business cycle can simply be defined as recurrent alternating phases of expansion and contraction in a large number of economic activities such as output consumption prices investment employment etc., and fiscal policy can be referred to as government operation of public spending and taxes so as to control economic variables such as output, inflation, interest rates, etc. Now different stages of the business cycle can have varied impacts on public finance. A recessionary phase of the business cycle can directly reduce government revenue because of falling income levels and increase government expenditure with rising unemployment levels. In contrast, a boom phase will result in higher government and personal income levels. Therefore, the level of economic activity can influence public finances automatically. However, the relationship between economic activity and public finance is not unidirectional rather; it is twofold. The magnitude and nature of public finances can affect the level of economic activity in any economy, making fiscal policy an important stabilization tool. This relationship was first emphasized by Keynes during the era of the great depression by stating that increased public expenditure is an effective measure to bring the economy out of the recessionary phase. Both monetary and fiscal policies have been used as a tool for economic stabilization. Fiscal policies were more dominant until the seventies, monetary policy as a stabilization tool rose to prominence after that. Nevertheless, in the wake of the current global slowdown, the debate about the effectiveness of fiscal policy has seen a revival. At the same time, the standard Keynesian theory suggests a sizeable positive impact on output and demand of a deficit-financed fiscal expansion (Keynesian effect). Empirical evidence points to a small effect. The debate is not just about the magnitude of the effect there is considerable disagreement regarding the primary direction of the effects. Concerning stabilization role, fiscal policy can be distinguished into two types:

1. Discretionary fiscal policy is a result of government interventions that are planned. Expansionary fiscal policy aims to boost demand and output in the economy either directly, through, more significant government expenditures, or indirectly, through tax reductions that stimulate private consumption and investment spending.
2. Non-discretionary fiscal policies are the part of fiscal policy that comes from the design of spending and taxes. As economic activity fluctuates, fiscal expenditures and taxes respond automatically in ways that stabilize the economy. For example, during an economic slowdown, government spending on employment benefits rises automatically as the unemployment rate rises. This increase in spending is automatic. Similarly, tax payments decline automatically when the economy goes into recession. Therefore are also known as automatic stabilizers.

[1]The terms non discretionary fiscal policies and automatic stabilizers will be used interchangeably.

Until the recession in 2008 was that government should use monetary policy and strengthen automatic stabilizers as a tool to tackle downturns; discretionary fiscal policy is not a good policy tool given the long lags involved in the process. The main arguments against the use of discretionary fiscal policy are:

1. Ricardian Equivalence: Rational economic agents will save any extra income expecting that taxes are likely to increase again at some future date.
2. Long lags[2] involved in changing fiscal policy: the time lag between implementing the policy and visible effects seen in the economy.
3. Government spending can also crowd out private spending by acting as a substitute for it.
4. Exchange rate appreciation and falling net exports can be an additional channel for crowding out demand.
5. Political business cycle: significant politically-motivated changes in fiscal policy.

The mistrust in discretionary fiscal policy as a countercyclical tool emanates not only because of long lags involved but also due to political cycles. The discretionary power can result in misuse of the funds to influence votes in a democratic society. In comparison, automatic stabilizers are by nature countercyclical to changes in economic activity and play an immediate role during downturns.

As defined by Fatas (2009), automatic stabilizers refer to "changes in government revenues and expenditures due to changes in the cyclical stance of the economy". These changes are automatically triggered as they are inbuilt in the tax codes and spending rules, not requiring government discretion. The stabilizing effects of automatic stabilizers are present in many macroeconomic variables: output, consumption, wages, and investment. Since these stabilizers are endogenous, timely, anticipated, they score over the discretionary fiscal policy. Moreover, the temporary nature of these stabilizers makes them beneficial from the point of view of fiscal sustainability (Fatas 2003). Taxes and transfers can smooth disposable income and help stabilize consumption under the assumption that Ricardian Equivalence does not hold (Fatas, 2009). The size of the stabilizers is essential for budget planning and for the assessment of progress towards fiscal targets throughout the cycle (Swanepoel and Schoeman, 2002). Various studies have identified the main determinants of the size of automatic fiscal stabilizers as:

1. Size of the government.
2. Degree of integration with the world economy.
3. Sensitivity of budget components to business cycle-revenue and expenditure structure.
4. Country specific factors like- income distribution; elasticity of labor, product and financial markets.
5. Nature of economic shock-external or domestic will determine the response of tax bases to changes in economic activity.

Generally, the size of automatic stabilizers tends to be associated with the size of government thus there is a likely trade-off between increasing stability via automatic stabilizers and increasing economic efficiency (Auberach, 2008; Van de Noord 2000). However, if focus is only on stabilizing the economy, these stabilisers will respond on their own to changes in economic activity whereas the other part of fiscal policy will depend upon government discretion. The government's falling revenue income during recessions may lead to a reduction in government expenditure to balance the budget. In contrast, rising levels of income during booms result in higher government expenditure. Thus, the fiscal policy may end up being procyclical. The countercyclical budgetary/fiscal policy has a stabilizing effect on the economy, whereas procyclical fiscal policy will end up destabilizing the economy

To conclude whether the policy is countercyclical or not requires disentangling the changes because of the policy's automatic part and discretionary part. Several authors Gavin and Perroti (1997), Kaminsky *et al.* (2004), Iltezki and Vegh (2008) have shown the procyclical stance adopted by emerging economies in their analysis. In fact the procyclical stance is more prominent during the slowdowns. Kaminsky

[2]In *Capitalism and Freedom* (1967) Friedman wrote: "There is likely to be a lag between the need for action and government recognition of the need; a further lag between recognition of the need for action and the taking of action; and a still further lag between the action and its effects. Source : History of economic thought, Wilkepedia.

et al. (2004) dubbed the phenomenon of procyclicity observed in developing countries as "when it rains, it pours". Apart from the credit constraint argument, the nature of shocks experienced in developing countries is also different. Shocks are more on the supply side. Concerning aggregate demand shocks, automatic stabilizers stabilize, but in the case of aggregate supply shocks, they do not allow for the adjustment of output that would be desirable in this case (Blanchard, 2000).

LITERATURE REVIEW

All schools of economic thought, whether monetarists, neoclassical, Keynesian, neo-Keynesian or Marxist schools, accept that business cycle is a reality of a market economy. However, the response in the form of a stabilization policy to be followed differs. Varvarigos (2008) argues that welfare maximization requires a complete counter-cyclical response to the occurrence of business cycles. Empirically, whereas the fiscal policy is contracyclical in developed countries, procyclical in developing countries Ilzetzki and Vegh (2008). Most of the research on the macroeconomic effects of fiscal policy has originated in the developed countries, mainly U.S.A., E.U., N.Z., and Australia. Blanchard and Perotti (2002), Perotti (2005), Fatás and Mihov (2001), Fatas (2003), and Mountford and Ulhig (2002) used V.A.R.s to identify fiscal policy shocks and quantify their consequences. The macroeconomic effects of a fiscal policy vary considerably for different countries. While the fiscal policy had a significant influence on cyclical conditions in New Zealand, according to Hargreaves, Karagedikli and Ozer (2007); Rahman (2005) indicates an insignificant impact of fiscal policy on real output growth for Bangladesh. Rezk, Avramovich and Basso (2007) analysis, using Perotti (2004) V.A.R. method on Argentina's logarithmic real variables, casts doubt upon some of the traditionally acceptable Keynes macroeconomic policy prescriptions. Castro (2002) empirically found evidence for small, though significant, effects of fiscal shocks on G.D.P., private consumption, private investment, interest rates and prices for Spain whereas Tenhofen and Wolff (2006) indicate significant effects for government expenditure and direct income tax but little effect of small indirect tax revenue shocks. Though the potential of automatic stabilizers as an effective countercyclical tool is a well recognized today but the empirical research is fairly limited. Blanchard (2004) noted that J.S.T.O.R. lists only 11 articles in the last twenty years related to automatic stabilization.

Fatas & Mihov (2001) were the first to show that measures of automatic stabilizers are highly correlated with government size. They analyzed the importance of automatic stabilizers using data from 20 countries and empirically studied the dynamic effects of discretionary fiscal policy using V.A.R. methodology for quarterly data from the U.S. They present strong evidence in favor of the hypothesis that large governments reduce output volatility (total or private). The result indicates that changes in taxes, transfers and government expenditure are the most effective fiscal policy tools.

Bella (2002) assessed the effectiveness of automatic fiscal stabilizers using French data for the period 1970-2000. Results indicate fiscal stabilizers dampen output variability by approximately 35-40% working through reducing in private investment fluctuations in pre 1985 and through a reduction in private consumption variability thereafter. Suescun (2007) evaluated the role of automatic stabilizers in Latin America by using a dynamic multisector small open economy model. Results are in synch with the Latin American business cycle facts, with stabilizers being comparatively more robust on the expenditure side. Swanponoel and Schoeman (2002) evaluated the effectiveness of tax revenue and unemployment insurance schemes as automatic stabilizers for the South African economy from 1970-2001. Results indicate that cyclical fluctuations in revenue are much larger than those of expenditure as unemployment benefits are only a small part of public finances in South Africa. A prominent role for automatic stabilizers was also observed in the latter half of the sample period. Floden (2009), on examining the responsiveness of the Swedish public budget to business cycle conditions between 1998 and 2009 found that sizeable change in three budget components (i) significant fall in the average level of personal income taxes, (ii) increase in the progressivity of personal income taxation and (iii) reduction in spending on unemployment compensation.

The existing literature on different aspects of fiscal policy points to the fact that the debate on the efficacy of fiscal policy as a stabilization policy is evolving. There is a vast contradiction in the result for different countries varying from insignificant to significant, both beneficial and adverse, the impact of fiscal policy on the macroeconomic variables. In short, its effects on output and other aspects of the macroeconomy are being intensely discussed. In the current decade, the emphasis has been shifted to analyzing the impact of fiscal policy shocks on economic activity using vector autoregressions. These models have provided a platform to compare the different theoretical pointss of view regarding the fiscal policy's effectiveness. However, most of the research has concentrated only on U.S. and other O.E.C.D. economies. With "endogenous business cycles" becoming an essential feature of Indian macroeconomic behavior, it becomes crucial for our government to have a clear understanding of the effects of different kinds of fiscal policy on economic activity. In India, recent studies have focused on a variety of issues: cyclicality (Chakraborty and Chakraborty, 2006); fiscal consolidation (Pattnaik, Raj and Chander, 2006); political budget cycles (Srivastava, 2007; Indira Rajaraman, 2004); the impact of the business cycle on the fiscal deficit (Rao, 2004) crowding out (Chakraborty, 2007; Mitra, 2005) and debt sustainability (Rangarajan and Srivastava, 2005).

Automatic stabilizers in India

Automatic stabilizers tend to be associated with the size of the government. The share of total expenditure and taxes in G.D.P. gives a rough idea of overall levels of stabilization provided by fiscal policy. On comparing the size of government for different country groups based on their income levels it can be seen that these stabilizers are comparatively weaker in developing countries (Table 1).

Table 1: Automatic Stabilisers

Country group (income)	Total Exp/ GDP (%)	Direct taxes (+SS) / Total revenue (%)	Transfers/ GDP (%)
Low income	19.5	26	6.5
Middle income	27.8	35.6	11.1
High income	32.9	53.6	18.4
India	14.16	64.35*	10.86

Source: *Serven (2009) I.M.F. workshop on fiscal policy; Handbook of Statistics R.B.I. (2008-09); * data does not include social security contribution*

Comparing the Indian data on an average share of taxes as a percentage of G.D.P. in pre-reform period with post-reform show a marginal improvement from 9.27% (1970-71 to 1990-91) to 9.73% (1991-92 to 2007-08) to finally increasing to (2008-09-2018-19) and share of transfers as a percentage of G.D.P. has increased from 6.65% (1970-71 to 1990-91) to 9.75% (1991-92 to 2007-08) to (2008-09 to 2018-19). Though the shares have increased as a percentage of G.D.P., yet it is far less than the developed nations. To examine automatic stabilizers' size and effectiveness, the first step is to identify the budget components capable of being automatic stabilizers. The broad categories are:

- Direct taxes
- Indirect taxes
- Unemployment benefits

For India's, direct taxes in total tax revenues have also witnessed a significant improvement in the post-reform period, with direct taxes exceeding the share of indirect taxes for the first time in 2003-04.

The size of automatic stabilizers also depends on the sensitivity of budget components on the sensitivity of budget components to economic cycle, which differs for each revenue and expenditure category. On the revenue side, corporate profit taxes are most sensitive to cyclical fluctuations. The cyclical sensitivity of personal income tax and indirect taxes is comparatively less than that of corporate taxes. Thus corporate income tax could be a potentially important source of automatic stabilization (Auberach, 2000). The share of personal income tax and corporate profit tax as a percentage of G.D.P. has been steadily rising in the post reform era (Table 2).

Table 2: Share of Personal Income Tax and Corporate Tax in G.D.P. (in percentage)

	2001-02	2009-10	2017-18
Personal income tax	1.4	2.06	2.46
Corporate tax	1.61	3.8	3.34

Source: *Basic data from Handbook of Statistics R.B.I.*

On the revenue front, the importance of taxes that are more sensitive to cyclical fluctuation is gradually increasing. On the whole, the correlation coefficient between the cyclical component of tax revenues and G.D.P. is 0.70 for the period 1970-71 to 2007-08 and has the correct sign. For the period 1970-71 to 1990-91 value of the correlation coefficient was 0.5 whereas for the period 1991-92 to 2007-08 it was close to0.9. Buoyancy estimate for taxes on income and profit (corporate tax and income tax) also gives an indication of the possible impact of fiscal policy. Buoyancy estimates are inclusive of both discretionary and automatic components of fiscal policy. To get a better understanding of the size of automatic stabilizers, elasticity estimates for the cyclically sensitive revenue categories is necessary. Most of the changes in buoyancy estimates reflect the effect of policy changes: reduction in tax rates, improved administration, better compliance, and widening of the tax base. A tax buoyancy ratio greater than one means that growth in tax revenue collection is higher than growth in G.D.P. Revenue buoyancy has been higher in an upturn (2003-04 to 2007-08) and lowers in the downturn (1997-98 to 2002-03; 2008-09 & 2009-10) for all revenue categories (Joshi, Business Standard, 2010).

Similarly, the buoyancy values of direct taxes have kept on fluctuating, ranging from 2.32 (2000-01) to 0.48 (2008-09) and 1.21 in (2018-19) (*Source: www.incometaxindia.gov.in*). This, in turn, would accentuate fiscal stress during downturn and reduce it during the upward phase of the business cycle. Revenue from Corporate tax and Income tax increase more than proportionally with G.D.P. during upturns. Together they account for roughly fifty percent of central total tax revenues and more than ninety percent of total direct taxes. In case of indirect taxes most important categories were excise and customs duty in the pre G.S.T. era. Buoyancy estimates of excise and customs duty show that they offset the total stabilizing effect of government revenues.

The structure of the Indian economy has undergone major changes, especially since the inception of economic reforms in 1991. With declining share of agriculture in national income and an increasing share of industry and services in total economic activity, the nature of business cycles has also changed from predominantly monsoon driven to a more market-oriented cycle. Since, there is no tax on agricultural income and taxes on income and profits are most sensitive to changes in G.D.P. Therefore, with the rise in the share of such taxes in total tax revenue in post-reform period, correlation also improved.

Revenue stabilizers generally have a significant impact on reducing cyclical fluctuations than stabilizers on the expenditure side. However, the expenditure stabilizers are more effective as they directly enter into demand (Swanponoel and Schoeman, 2002). On the expenditure side, the most important budget component that can play an important role in macroeconomic stabilization has a direct link with the level of employment. Till recently, India[3] did not have any unemployment program that provided a legal right to employment. The N.R.E.G. program (2005) renamed as M.N.R.E.G.A. provides employment to rural unskilled labor in all country districts. During period of high macroeconomic volatility, M.N.R.E.G.A. can help in smoothening of consumption levels of rural poor who have almost no assets and access to credit, thus acting as a safety net for the vulnerable sections in the rural areas. Efficient automatic stabilization would also require effective expenditure stabilizers that the national rural guarantee programme could provide for urban and rural areas. The mass scale reverse migration during 2020 has highlighted the deplorable conditions of migrant laborers. Their plight cannot be ignored but should be taken care of by introducing a solid social support program by combining the existing poverty eradication and unemployment programs under one umbrella.

CONCLUSION

Global financial crisis of 2008 and the Covid 19 led slowdown have brought Keynesian fiscal stabilization policies back to the forefront of all academic debates. But what the world is experiencing should be treated as an exceptional situation which should not be used to advance the case of fine tuning the economy every time using discretionary fiscal measures. The pre-crisis broad macroeconomic consensus still holds, and the task of stabilization should first be left to monetary policy. On the fiscal front government should rely more on rule-based inbuilt stabilizers for short-term management of cyclical fluctuations in case of demand shocks, and long-run fiscal policy should focus more on growth and developing enabling

[3]State of Maharashtra was the first to start employment guarantee programme in 1972

factors to attract more investment. Fiscal stabilizers on the expenditure side should be strengthened to provide an adequate safety net to economically vulnerable sections of society. Enactment of M.N.R.E.G. act is a step in the right direction. The Approach Paper to the 11th Plan had mentioned that endogenous business cycles had become a permanent feature of the Indian macroeconomic scenario. Tackling it through appropriate fiscal and monetary measures is vital provided that recognition is early enough. Therefore, the changed nature of business cycles from predominantly monsoon-driven to a more market-oriented cycle requires an in-depth analysis of business cycles. External factors could also result in a significant slowdown of our economy in the future, which is evident during the times of Covid. To remain prepared for such a scenario, a thorough understanding of the effects of various stabilization policies on economic activity is fundamental. The role different types of fiscal policy can play in stabilizing the economy will help in preparing us for the future when these shocks may become a regular part of our economy. Moreover, in the case of India, high public debt to GDP G.D.P. ratio and a large amount of committed expenditure on interest payments and defense defense act as a limiting factor for the discretionary fiscal policy. Even with automatic stabilizers an in-depth analysis is required to take into account the supply constraints. The emphasis of research should be to develop stabilizers on the supply side and expenditure stabilizers that can help in countering the supply shocks.

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