Fiscal Policy: Taking and Giving Away

Governments promote stable and sustainable growth through their power to spend and tax

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FISCAL POLICY influences the economy through government spending and taxation, typically to promote strong and sustainable growth and reduce poverty. The role and objectives of fiscal policy gained prominence during the global economic crisis, when many governments stepped in to support financial systems, jump-start growth, and protect vulnerable groups from the impact of the crisis. In a communiqué following their London summit in April 2009, leaders of the Group of 20 industrial and emerging market economies announced that they were undertaking "unprecedented and concerted fiscal expansion." What did they mean by fiscal expansion? And, more generally, how can fiscal tools boost the world economy?

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 target activity indirectly by influencing the money supply through adjustments to interest rates, bank reserve requirements, and purchases and sales 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 how economic resources are used. An equation of national income accounting that measures an economy's output—or gross domestic product (GDP)—according to expenditures shows how this happens:

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

On the left side is GDP—the value of final goods and services produced in the economy. On the right side are the sources of aggregate spending and demand—private consumption (C), private investment (I), purchases of goods and services by the government (G), and foreign demand for domestically produced goods—exports minus imports (net exports, NX). This equation shows that governments affect economic activity (GDP) by controlling G directly and influencing C, I, and NX indirectly, through changes in taxes, transfers, spending, and borrowing. Fiscal policy that raises aggregate demand directly through greater government spending is typically called expansionary or "loose." It is often considered contractionary or "tight" if it reduces demand through lower spending.

Fiscal policy objectives vary. In the short term, governments may focus on macroeconomic *stabilization*—for example, spending more or cutting taxes to stimulate an ailing economy or slashing spending or raising taxes to rein in inflation or reduce external vulnerabilities. The longer-term aim may be sustainable growth or less poverty through *supply-side* action to improve infrastructure or education. These objectives may be shared broadly across countries, but their relative importance differs with country circumstances. Short-term priorities may reflect the business cycle or response to a natural disaster or global food or fuel price spikes. The longer-term drivers may be development, demographics, or natural resource endowments. Low-income countries might tilt spending toward primary health care in an effort to reduce poverty, whereas advanced economies might favor pension reform to target looming long-term costs related to an aging population. In an oil-producing country, policymakers might gear fiscal policy toward broader macroeconomic developments by moderating procyclical spending—both by limiting bursts of spending when oil prices rise and by refraining from painful cuts when they drop.

Response to the global financial crisis

The global financial crisis that had its roots in the 2007 meltdown in the US mortgage market is a good case study in fiscal policy. The crisis hurt economies around the globe. Financial sector difficulties and flagging confidence hit private consumption, investment, and international trade (all of which affect output, GDP). Governments tried to boost activity through two channels: automatic stabilizers and fiscal stimulus—that is, new discretionary spending or tax cuts. *Stabilizers* kick in as tax revenue and expenditures change and do not depend on government action. They have to do with the business cycle. For instance, as output slows or falls, the amount of taxes collected declines because corporate profits and taxpayers' incomes are lower, particularly when progressive tax structures place higher-income earners in higher tax brackets. 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 soften the effects of a downturn. In addition, although discretionary measures can be tailored to stabilization needs, automatic stabilizers are not subject to implementation lags, as discretionary

measures often are. (It can take time, for example, to design, get approval for, and implement new road projects.) Moreover, automatic stabilizers—and their effects—wind down on their own as conditions improve.

Stimulus may be difficult to design and implement effectively and to reverse when conditions pick up. In many low-income and emerging market economies, however, institutional limits and narrow tax bases mean that 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 to target the government's crisis response to those most directly in need.

Fiscal ability to respond

The exact response ultimately depends on the fiscal space for new spending or tax cuts—that is, how much access the government has to additional financing at a reasonable cost or its ability to reorder its existing expenditures. Some governments were not able to respond with stimulus during the crisis because potential creditors believed additional spending and borrowing would put too much pressure on inflation, foreign exchange reserves, or the exchange rate—or delay recovery by taking away resources from the local private sector (also known as crowding out). Creditors may have doubted some governments' ability to spend wisely, reverse stimulus once in place, or address long-standing structural weaknesses in public finances (chronically low tax revenue because of poor tax structure or evasion, weak control over local government or state-owned-enterprise finances, rising health costs, aging populations). Sometimes, severe financing constraints have forced governments to cut spending in the face of declining revenue (functioning stabilizers). If inflation is high or there is an external current account deficit, fiscal stimulus could be ineffective and even undesirable.

The size, timing, composition, and duration of stimulus matter. Policymakers generally aim to tailor measures to their estimates of the output gap—the difference between expected output and output of the economy at full capacity. A measure of the effectiveness of the stimulus—or, more precisely, how it affects output growth (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, and the country's fiscal position after the stimulus is considered sustainable. Multipliers can be small or even negative if the expansion raises concern about immediate or longer-term sustainability. In that case the private sector would likely counteract government intervention by saving more or even moving money abroad instead of investing or consuming. Multipliers tend to be higher for spending measures than for tax cuts or transfers and lower for small open economies (in both cases, because of the extent of leakage).

Governments face a trade-off between targeting stimulus to the poor, which tends to yield full spending and a strong economic effect; funding capital investment, which may create jobs and help bolster longer-term growth; and tax cuts, which may encourage hiring or new capital equipment purchases. In practice, governments have taken a balanced approach that includes measures in all these areas.

As for timing, it can take a while to implement spending measures (program design, procurement, execution), and once in place the measures may outlive the need. However, if the downturn is expected to be prolonged (like the recent crisis), concern over lags may be less pressing: some governments stressed implementation of shovel-ready projects that were vetted and ready to go. This is why 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 system that taxes wealthy 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 and constraints seem less binding. Elsewhere, formal review or expiration (sunset) mechanisms help ensure that new initiatives do not outlive their purpose. Finally, medium-term fiscal frameworks with comprehensive coverage and assessment of revenue, expenditures, assets and liabilities, and risks help improve policymaking over the business cycle.

Big deficits and rising public debt

Fiscal deficits and public-debt-to-GDP ratios have expanded sharply in many countries because of the effects of the crisis on GDP and tax revenue and the cost of the fiscal response. Support and guarantees for the financial and industrial sectors have added to concerns about the financial health of governments. Many countries can afford a moderate fiscal deficit for an extended period when domestic and international financial markets and international and bilateral partners are confident that these economies can meet present and future obligations. But deficits that grow too large and linger too long may undermine that confidence. Aware of these risks, the IMF in late 2008 and early 2009 called on governments to establish a four-pronged fiscal policy strategy to help ensure solvency: stimulus should not permanently affect 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 commit to health care and pension reform. Even though the worst effects of the crisis are behind us, fiscal challenges remain, particularly in advanced economies in Europe and North America, and this strategy is as valid as ever. FD

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