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Effectiveness of countercyclical fiscal policy: Evidence from developing Asia ☆

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A B S T R A C T

Can discretionary fiscal policy effectively stimulate output? This paper examines this question in the context of developing Asia, where many countries implemented fiscal stimulus measures to support domestic demand during the global crisis. Economic conditions normalized after the crisis but growth in Asia has slowed down since. We examine historical data from 10 emerging Asian countries to assess whether countercyclical fiscal policy can support future growth in the region. Our examination is based on identifying shocks by restricting the contemporaneous relation between fiscal and non-fiscal variables. Our most significant and consistent finding is that in developing Asia, tax cuts have a greater countercyclical impact on output than government spending. This implies there is some scope for countercyclical tax adjustments so long as fiscal sustainability is not compromised.

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1. Introduction

The issue of whether fiscal policy enhances or retards long-run economic activity has long been debated in the literature. Among others, two contrasting views come from the basic Keynesian and Ricardian theories. In the simple Keynesian world of rigid prices, aggregate demand determines output. In this world, consumption responds to current income, and fiscal expansion has a multiplier effect on growth.[1] In contrast, the fiscal multiplier is zero under Ricardian equivalence between taxes and debt in a dynamic framework. In this case, Ricardian consumers are forward-looking and fully aware of the

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[1] Fiscal multiplier – the increase in output due to a one dollar increase in government spending or one dollar reduction in taxes – is the underlying concept which measures how effectively tax cut or government spending stimulates output.

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government's intertemporal budget constraint. Since they know that a tax cut today will be financed by higher taxes in the future, their consumption does not change because their permanent income is unaffected.[2] Similarly, the knowledge that an increase in government spending by borrowing today will be offset by future spending cuts leaves output unaffected.

The effectiveness of countercyclical fiscal policy in reality will depend not only on its size but also on its composition – i.e., the relative importance of tax cuts versus government spending. Intuitively, it is tempting to believe that government spending has a bigger influence on output since it has a more immediate impact on aggregate demand. Public spending involves government's direct purchase of goods and services including spending on public works and infrastructure such as roads and power plants. On the other hand, tax cuts have a less direct impact on aggregate demand since their effectiveness ultimately depends on the willingness of households and firms to spend the additional income resulting from tax cuts. However, the relative effectiveness of tax cuts versus government spending in boosting aggregate demand is ultimately an empirical issue which cannot be settled by economic intuition alone.

This paper therefore seeks to examine these issues in the context of developing Asia. While the region has a relatively limited experience of using fiscal policy for countercyclical purposes, many Asian countries boldly implemented large fiscal stimulus programs during the global financial and economic crisis of 2008–2009. According to conventional wisdom, the fiscal expansion helped the region stave off severe recession during the crisis by supporting aggregate demand at a time of plummeting private and external demand. Going forward, the key question is whether countercyclical fiscal policy can smooth out the business cycles in an uncertain and volatile post-crisis world.

Typically, fiscal policy tends to be less countercyclical in developing countries than in high-income countries. For example, Kaminsky et al. (2005) demonstrate that emerging markets' fiscal policies are predominantly *pro-cyclical* and thus exacerbate rather than moderate the business cycle. Moreover, in low-income countries, automatic stabilizers are pro-cyclical due to institutional failures and lack of access to finance during economic downturns, as in Kraay and Servén (2008). This means that governments in these countries increase spending in good times and cut back in bad times, potentially impairing fiscal sustainability. Ilzetzki and Végh (2008) provide further evidence that fiscal policy, especially government expenditure, is indeed pro-cyclical in developing countries. Besides, with large informal sectors whose activities remain unrecorded, developing-country governments tend to face large fluctuations in their tax bases compared to advanced countries, as in Talvi and Végh (2005). Such cyclical fluctuations in tax bases can create large revenue shocks with bigger output effect, especially since the tax-GDP ratio averages only about 9–11% in low-income countries, including those in South Asia and in East Asia and Pacific, in comparison with 14–16% in high-income countries.[3]

In addition, since developing country governments do not follow strict fiscal policy rules (or automatic stabilizers),[4] discretionary fiscal policy could account for much of the changes in fiscal activity. In particular, the experience of developing Asian countries shows that the role of automatic stabilizers is relatively small and fiscal policy interventions have been primarily discretionary, as in Jansen (2004). Also, Ilzetzki et al. (2011) contribute to this debate on the real effects of fiscal stimuli by showing that the output effect of an increase in government expenditure is larger in industrial than in developing countries. Finally, a widespread perception – a perception which will be empirically investigated in this paper – that fiscal stimulus mitigated the impact of the global crisis on Asia's output during this crisis period has awakened interest in countercyclical fiscal policy throughout the region. All of these factors motivate us to examine the effectiveness of fiscal shocks in the context of Asia.

Using historical quarterly time-series data for 10 emerging Asian countries within a Structural Vector Auto-regression (SVAR) framework, this paper analyzes what type of fiscal policy – tax cuts versus higher spending – works best during troughs in business cycles. The most significant and consistent finding from our analysis is that a government revenue (tax) shock has a bigger countercyclical output effect than a government expenditure shock in developing Asia. More specifically, the comparison of output multipliers reveals that deficit-financed tax cuts stimulate economic activity whereas deficit spending has a largely insignificant impact on output.

2. Countercyclical fiscal policy – empirical evidence

Until recently the business cycle effects of fiscal policy were not given much attention. In this empirical literature, there are substantial recent studies on this topic in the context of key major economies but much disagreement remains. Most studies apply SVAR methods aiming at identifying the usual reactions of the aggregate variables to the exogenous shocks in fiscal policy. See for example Blanchard and Perotti (2002), Burnside et al. (2003), Galí et al. (2007), and more recently Burriel et al. (2010) and Mountford and Uhlig (2009). However, the evidence is mixed and most of the papers focus on OECD, G7 and other industrial economies.

The evidence from a large and growing number of studies that have estimated the size of the fiscal multiplier is far from conclusive. Those studies have produced a wide range of estimates, ranging from negative to more than one. For example, according to Spilimbergo et al. (2009), the overall evidence from the literature indicates that the multiplier for government spending is larger than that for tax cuts. Spilimbergo et al. (2009) put forth the following rule of thumb for government

[2] If a tax cut is permanent, then private consumption could go up, although it has inter-generational implications. Thus there is no unambiguous effect of a tax-cut, making it an empirical issue for further investigation.

[3] http://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS/countries/8S-4E-XD-XM-XO?display=graph.

[4] For the spending stabilizer, there must be an automatic increase (reduction) in total government expenditure when output gap declines (increases), whereas for the tax stabilizer, the tax rate should automatically fall (rise) when output gap falls (rises).

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