M.Com. (Applied Economics)

Semester IV

Public Economics

Broad Topic

Structural Fiscal Deficits

Teacher

Nagendra Kumar Maurya
Department of Applied Economics

The objective of stabilization of fiscal policy can be obtained by two ways:

(i) Automatic stabilisers
(ii) Discretionary stabilisers

(i) Automatic stabilisers

Automatic stabilizers are those measures, which come into action automatically, when any destabilizing phenomenon like inflation or unemployment, come into play. This either corrects the imbalance or moderates it impacts.

When there is inflation in the economy, although the government's expenditure increases, there is automatic increase in government's tax revenue also. This is because there is an increase in incomes of people and consequently the tax on these incomes also increases. Moreover, since incomes of the people move to the higher tax brackets, the tax receipts increase even faster. As far as indirect tax receipts are concerned, there is a boom in indirect tax receipts also. Most of the indirect taxes are on ad-valorem basis, when prices increase there is an automatic increase in tax receipts also.

In this way, we see that this is an automatic stabilizer. The government is not required to take any specific measure to boost its revenue to meet additional expenditure. The increase in tax revenue is normally sufficient to meet this expenditure[1].

Mishra and Trivedi (2015) rightly said "The automatic channel arises due to the natural linkage between business cycles and government budget balances as some components of the government's budget adjust automatically to cyclical changes in the economy".

(ii) Discretionary stabilisers

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[1] The above section is taken from the Vaishampayan (2011, pp. 548-549)

It essentially refers to deliberate or voluntary changes in government spending and taxation (in short, deliberate changes in fiscal policy) in response to changes in economic activity. Before Keynes, the discretionary fiscal policy was almost non-existent. The discretionary fiscal policy may be expansionary or contractionary. Expansionary discretionary policy will lead to lower taxes and higher government expenditure. And the reverse is true in the case of contractionary fiscal policy. This is also known as counter-cyclical fiscal policy.

Automatic Vs Discretionary

A discretionary fiscal policy involves political economy issues, particularly with regard to the government's decision and implementation. Mishra and Trivedi (2015)- "The effect of automatic stabilisers depends on the size of the government and the responsiveness of taxes and expenditures to cyclical changes. The major advantage of automatic stabilisers vis-à-vis a discretionary policy is that fiscal expansion through the automatic channel is reversed on its own when the economic cycle improves. Hence, one is not really worried about the consequences of fiscal worsening on account of this channel".

However, at times automatic stabilisers may not be adequate, particularly for large economic fluctuation necessitating the use of the discretionary fiscal policy. This requirement is felt the most during large output shocks or recessions to 'get the economy going again'. Considering the fact that a discretionary fiscal policy is not automatically reversed when the economic condition improves, its non-reversal in a timely manner is likely to give rise to a potential deficit problem (Mishra and Trivedi, 2015).

Economic cycle, fiscal deficit and fiscal policy

Analysing the fiscal health of nation or nature of fiscal policy adopted on the basis of overall value of fiscal deficit may sometime give wrong conclusions. Fiscal balance (the gap between revenue and expenditure means fiscal deficit (or fiscal surplus)) is also affected by the economic cycles means by business cycles. The movement in fiscal deficit may move up and down with the movement of business cycles which means the real fiscal deficit/surplus may be more or less than the deficit reflected in boom or recession period. Recognizing this, the concept of cyclically adjusted budget balances, i.e., the fiscal balance corrected for the business cycle impact, has gained popularity in the recent years. This is basically the fiscal balance that would be observed if the economy were operating at its potential GDP.

Mishra and Trivedi (2015) – "To show graphically in a simplistic manner, if actual output is denoted by Y'' (that follows a cycle) and Y* = Y' is the long-term consistent level of output (potential output), the structural fiscal balance (SFB) is determined by the level of revenues consistent with potential output, represented by R(Y'), assuming that expenditures do not have a structural component. During an upturn when Y''>Y', observed revenues will also be higher than structural revenues, or R(Y'') > R(Y'). The gap between observed revenues and structural revenues – implicitly, a function of the output gap – denotes the cyclical fiscal balance (CFB), obtained by residual.

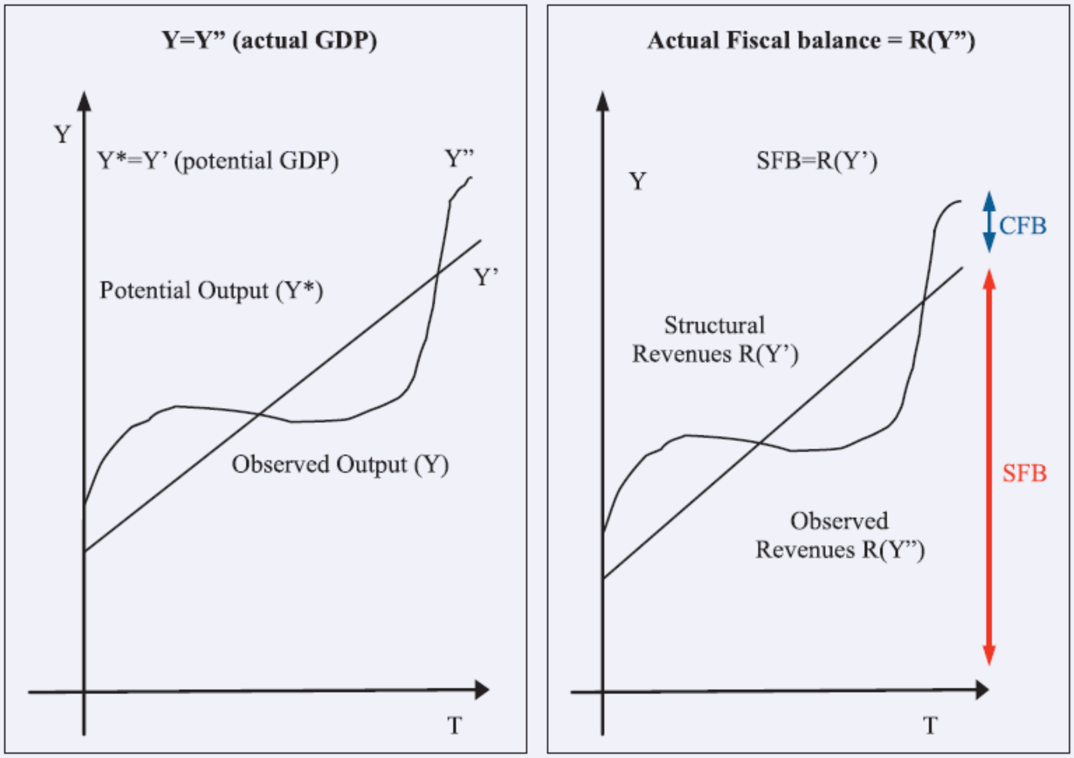
In the chart 1, the horizontal axis shows tax revenue and the vertical axis shows GDP. Let us first talk about left hand portion of the chart. The left hand portion shows the classification of Actual GDP into long-term trend GDP (which is also known as potential GDP which means if there was no boom or recession then what would have been the level of GDP on the basis of previous trend) and cyclical-component of GDP. The curvature line shows the movement in actual GDP which is moving with the change in business cycle. The straight line is showing the long-term trend GDP or potential GDP. The difference between these two is the cyclical GDP.

We can say

Observed or Actual GDP = Potential GDP + Cyclical GDP

The cyclical GDP component may positive (in times of boom) or may be negative (in times of recession).

Chart 1: The Concept of Structural Fiscal Balance



Source: Oreng, 2012

Now look at the right component of the chart which is more relevant for our discussion. First you should be careful that the curves mentioned here are showing the revenue collections not GDP. You can also notice that the curves are starting from the lower intersection points than the first curve, another indication that both graphs are not same. The curvature line is showing the observed revenue collections (as a function of the observed GDP) which moves with economic cycles. However, the long-term trend in revenues is shown by the straight line (the potential revenue as function of the potential GDP). So, the potential revenue which is a function of potential GDP means the revenue level which would have prevailed at potential GDP level is known as structural revenue. And, the gap between observed revenues and structural revenues is known as cyclical fiscal revenues.

Thus, deriving from this analysis, we can say that

Observed fiscal deficit = Structural deficit (which is function of potential output) + Cyclical fiscal deficit

The structural deficit is also known as cyclically adjusted fiscal deficit.

For more clarity: (for avoiding definitional issues of deficit concepts, I am using simple budget deficit to explain the terms)

Observed Budget Deficit = Expenditure – Observed Revenue

Observed Budget Deficit (or Cycle Budget Deficit) = Expenditure – (Structural Revenue + Cyclical Revenue)

Structural Budget Deficit (or Cycle Adjusted Budget Deficit) = Expenditure – Structural Revenue