Counter-Cyclical Fiscal Policy

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In News: Counter-cyclical fiscal policy refers to the steps taken by the government that go against the direction of the economic or business cycle.

What is countercyclical fiscal policy?

- A counter-cyclical fiscal policy refers to a strategy by the government to counter boom or recession through fiscal measures.
    - It works against the ongoing boom or recession trend; thus, trying to stabilize the economy. Understandably, countercyclical fiscal policy works in two different directions during these two phases.
- **Countercyclical fiscal policy during recession**
    - Recession is a business cycle situation where there is slowing demand and falling growth in the economy.
    - Here, the Government's responsibility is to generate demand by fine-tuning taxation and expenditure policies.
    - Reducing taxes and increasing expenditure will help to create demand and produce upswing in the economy.

Countercyclical fiscal policy during boom

- In the case of a boom, economic activities will be on upswing.
- Amplifying the boom is disastrous as it may create inflation and debt crisis and the government's responsibility here is to bring down the pace of

economic activities.

- Increasing taxes and reducing public expenditure will make the boom mild.
- Thus, slowing down demand should be the nature of countercyclical fiscal policy during a boom.

Need for Active Counter-cyclical Fiscal Policy

- COVID-19 pandemic has created a significant negative shock to demand, an active fiscal policy can ensure the full benefit of seminal economic reforms taken by the Government.
- As the IRGD is expected to be negative in the foreseeable future, a fiscal policy that provides an impetus to growth will lead to lower, not higher, debt-to-GDP ratios.
- According to the Survey, simulations undertaken till 2030 highlight that, given India's growth potential, debt sustainability is unlikely to be a problem even in the worst-case scenarios.
- The Economic Survey has highlighted the desirability of using counter-cyclical fiscal policy to enable growth, noting that while it is necessary to smooth out economic cycles, it becomes critical during economic downturns. This is because fiscal multipliers which capture aggregate return derived from the economy from an additional rupee of fiscal spending, are greater during economic crises than boom.
- In a country like India with a large workforce in the informal sector, counter-cyclical fiscal policy becomes even more important, it advised.
- The Survey also indicates that a well-designed expansionary fiscal policy stance can contribute to better economic outcomes in two ways.
    - First, it can boost potential growth with multi-year public investment packages that raise productivity.

    - Second, it can mitigate the risk of Indian economy falling into a low wage-growth trap, like Japan.
- Further, at a time of excessive risk aversion in the private sector, as seen during an economic crisis, risk-taking via public investment can catalyse private investment, leading to a crowding in, then a crowding out. With the National Infrastructure Pipeline (NIP) already laying out the agenda for ambitious public spending, fiscal policy catering to its funding can boost growth, productivity, generate higher-paying jobs and thereby be self-financing.

Procyclical fiscal policy

- Procyclical is the opposite of countercyclical.
- Here, fiscal policy goes in line with the current mood of the business cycle; amplifying them.
- For example, during the time of boom, the government makes high expenditure and doesn't hike taxes.
- Thus, the boom grows further.
- Such a policy is dangerous and brings instability in the economy.
    - **Boom**: total government spending as a percentage of GDP goes up and tax rates go down, increasing government deficit.
    - **Recession:** total government spending as a percentage of GDP goes down and tax rates go up, decreasing government deficit.
- So procyclical fiscal policy is undesirable for the economy.