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ISSN : 2454 – 308X | Volume : 04 , Issue : 02 | January – March 2018

A Review of India's fiscal policy architecture

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Abstract

We investigate the macroeconomic effects of fiscal policy using a Bayesian Structural Vector Autoregression (B-SVAR) approach. We identify fiscal policy shocks via a partial identification scheme, but also: (i) include the feedback from government debt; (ii) look at the impact on the composition of output; (iii) assess the effects on asset markets; (iv) use quarterly data; and (v) analyse empirical evidence from the US, the UK, Germany and Italy. The results show that government spending shocks, in general, have a small effect on Gross Domestic Product (GDP); lead to important 'crowding-out' effects; have a varied impact on housing prices and generate a quick fall in stock prices. Government revenue shocks generate a mixed effect on housing prices and a small and positive effect on stock prices. The empirical evidence also suggests that it is important to explicitly consider the government debt dynamics in the model.

ISSN 2454-308X
9 770024 543081

Keywords: fiscal policy, Bayesian structural VAR, debt dynamics

Introduction

Fiscal policy deals with the taxation and expenditure decisions of the government. Monetary policy, deals with the supply of money in the economy and the rate of interest. These are the main policy approaches used by economic managers to steer the broad aspects of the economy. In most modern economies, the government deals with fiscal policy while the central bank is responsible for monetary policy. Fiscal policy is composed of several parts. These include, tax policy, expenditure policy, investment or disinvestment strategies and debt or surplus management. Fiscal policy is an important constituent of the overall economic framework of a country and is therefore intimately linked with its general economic policy strategy.

Fiscal policy also feeds into economic trends and influences monetary policy. When the government receives more than it spends, it has a surplus. If the government spends more than it receives it runs a deficit. To meet the additional expenditures, it needs to borrow from domestic or foreign sources, draw upon its foreign exchange reserves or print an equivalent amount of money.1 This tends to influence other economic variables. On a broad generalisation, excessive printing of money leads to inflation. If the government borrows too much from abroad it leads to a debt crisis. If it draws down on its foreign exchange reserves, a balance of payments crisis may arise. Excessive domestic borrowing by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the „crowding out' of private investment. Sometimes a combination of these can occur. In any case, the impact of a large deficit on long run growth and economic well-being is negative. Therefore, there is broad agreement that it is not prudent for a government to run an unduly large deficit. However, in case of developing countries, where the need for infrastructure and social investments may be substantial, it sometimes argued that running surpluses at the cost of long-term growth might also not be wise (Fischer and Easterly, 1990). The challenge then for most developing country governments is to