REVISITING FISCAL POLICY AND A CASE FOR AUTOMATIC STABILISERS IN URBAN INDIA

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Abstract
Every crisis teaches important lessons. India's urban poor have borne the brunt of large scale employment due to lockdowns and restrictions enforced due to the COVID-19 pandemic. This brings to the forefront an important issue of developing a social security network for the urban poor which has the capacity to function as an automatic stabiliser during crises. In this paper, I have put forward a case for developing expenditure stabilisers intended for urban India and suggested a way to design and finance it. The role of discretionary fiscal policy in the changing environment is also discussed with reference to the new macroeconomic consensus (NMC).

INTRODUCTION

The Global Financial Crisis of 2008 and the recent slowdown of the economy partly owing to the COVID-19 crisis have shown the efficacy of fiscal policy during these stressful times. It is a well known fact that the use of discretionary fiscal policy has certain drawbacks in the form of time lags. On the other hand, the automatic fiscal stabilisers (AFS) inbuilt in the system are not handicapped by time and information lags that are involved in the decision making process.

Every crisis highlights the need for developing new automatic stabilisers and strengthening the existing ones. This is happening irrespective of the status of development of the economy. During the current COVID-19 crisis, countries in Europe with comparatively strong stabilisers benefitted

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from it. The USA is also looking for a way to further strengthen them. The effective AFS will help the governments in developing countries to leave the general task of stabilization to AFS and monetary policy (except in exceptional situations as seen during the recent global slowdown) and use fiscal policy to achieve the objectives of economic growth and provision of quality economic and social infrastructure. For a country like India, with large population and where only 0.23% of the population pay 77% of the total income tax collected in 2017-18, AFS working on the revenue side are not enough. Having strong expenditure stabilisers is a requirement that India should prepare itself to deal with as it becomes more integrated with the world economy. Since 1950, the proportion of population living in urban areas in India has doubled with around 65% of the population now living in rural areas and 35% living in urban areas. Therefore, any cyclical or external disturbance created by a shock will have an impact in both rural and urban areas. The official data shows that the urban unemployment rate more than doubled in the first three months of the lockdown from the corresponding quarter a year ago (20.9% from 8.9%)[2]. India had imposed the strictest form of lockdown as compared to the rest of the world. It also resulted in mass scale reverse migration from urban to rural areas. The GDP shrank by 24.4%, an unparalleled level, during the first quarter of fiscal year 2021. Therefore, it becomes all the more important to think about the plight of the urban poor.

The aim of this paper is to look at the ways in which the Indian government can try to provide support to its residents in urban areas just as it is doing for rural poor. This paper is divided into five sections. The following section, the second section, deals with the literature and background of AFS followed by a section on slowdown trends in India and existing stabilisers in India. The fourth section suggests an AFS for urban India followed by the final concluding section.

BACKGROUND

Between the mid-1980s to the mid-2000s, developed economies experienced satisfactory real output growth, low inflation and low unemployment rates. This led to emergence of a new macroeconomic consensus (NMC) among Friedman's monetarists' followers, Lucas' rational expectations supporters, New Classical economists of the real business cycles and even New Keynesians regarding the role of monetary and fiscal policies. According to this consensus, there will be no long run trade-off between inflation and unemployment with both the Phillips curve and the real output level being vertical in the long run. The trade-off may occur in the short term. As Nassiff et al (2020) pointed out, in NMC

[2] Source: Quarterly periodic labour force survey

fluctuation, the output associated with changes in aggregate demand are mainly because of either the money illusion (Friedman,1968) or Lucas' price surprise argument (Lucas 1973), or even temporary price or wage rigidities (Akerlof &Yellen, 1985). The resulting policy implication is that (i) the role of monetary policy is to focus on price stability with inflationary expectations as the monetary anchor (ii) due to the assumption of Ricardian equivalence, the counter-cyclical power of expansionary fiscal policy is discarded. The NMC seems to be in need of introspection after the GFC of 2008 and the current recession giving rise to a new consensus which recognises the importance and increasing role of the fiscal policy in times to come. This is despite the fact that DFP has its inherent weaknesses associated with time lags, information lags, and Ricardian Equivalence. The review of empirical literature on the impact of fiscal policy on macroeconomic variables shows that there is a vast contradiction in the results for different countries varying from insignificant to significant, both beneficial and adverse (Yadav, 2014). When it comes to automatic stabilisers, their potential as an effective counter-cyclical tool is well recognized but empirical research on the same is fairly limited (Blanchard, 2006).

Van de Noord (2000) and Fatas & Mihov (2001; 2003) were the first to show that measures of automatic stabilizers are highly correlated with government size. Suescun (2007) evaluated the role of automatic stabilizers in Latin America by using a dynamic multi-sector small open economy model. The results are in sync with the Latin American business cycle facts, with stabilizers being comparatively stronger on the expenditure side. For the Indian economy, findings by S.Yadav et al (2012) indicate that the tax variable has a larger impact on private consumption as compared to the government spending variable. In the short run, the impact of expansionary fiscal shocks follow Keynesian tradition, but the long run response is mixed.

Rejda (1966) was the first to empirically analyze the effectiveness of unemployment insurance as automatic stabilisers. Swanponoel , J.A. & Schoeman, N.J. (2002) on evaluating the effectiveness of tax revenue and unemployment insurance schemes as automatic stabilizers for the South African economy from 1970-2001, found that cyclical fluctuations in revenue are much larger than those of expenditure as unemployment benefits are only a small part of public finances in South Africa. Floden (2009) examined the responsiveness of the Swedish public budget to business cycle conditions between 1998 and 2009. Peichi, A. et al (2010) compared the existing stabilisers in the USA and in Europe. They found that social transfers played a key role in stabilising disposable income and consumer demand. 38% of a potential income shock will be absorbed

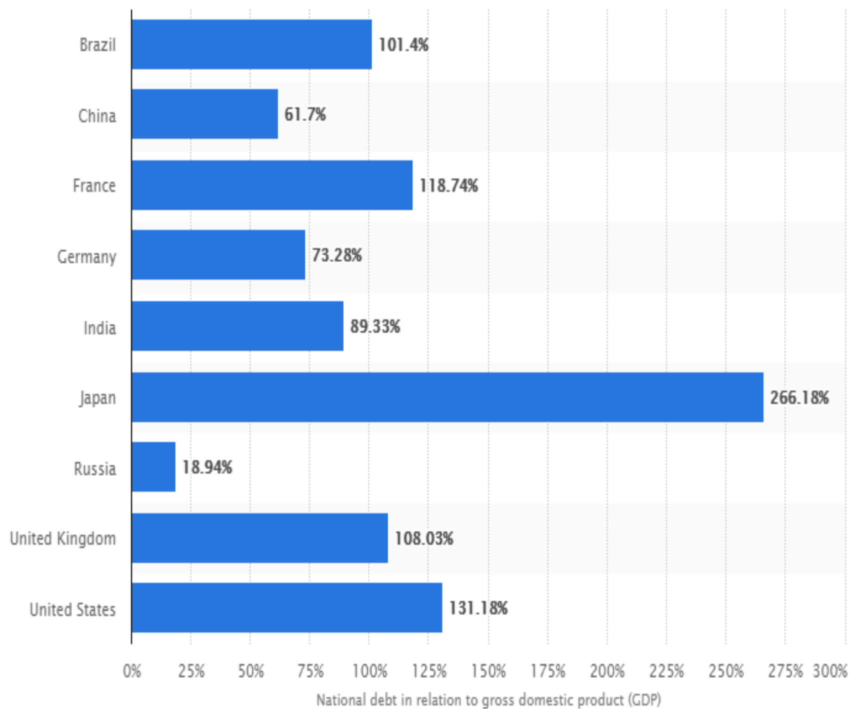
by automatic stabilisers in the EU as compared to 32% in the case of the US. Unemployment benefits which form a large part of the stabilisation programme in Europe will absorb 47% of the shock in comparison to only 34% in the US.

Social transfers, especially the unemployment insurance in Europe, has always played a key role in stabilisation (Todter et al, 2004) (Darby, J. and Melitz J,2008), even during the current crisis (Bouabdallah et al, 2020). The US also relied heavily on monetary transfers for supporting its population. In fact, the focus of research in recent times has been shifting to analyse the role of discretionary and non-discretionary fiscal policies in the stabilisation of the economy (Lee, V. and L. Sheiner, L 2019; Dolls, M., et al.2019; Brătian, V., 2015; and Yadav,S., et al. 2012). More recently, Blanchard and Summers (2020) argued for a bigger role of fiscal policy and semi-automatic stabilizers designed for reducing unemployment slumps rather than output recessions.

Even though restraining the role of the government and embracing privatisation is constantly being emphasised, the role and responsibility of the government will only continue to increase. In such a scenario, the role of discretionary fiscal policy becomes more relevant. Unfortunately however, it has been observed that countries do not adhere to the Keynesian prescription of following counter-cyclical policies in totality. Generally, it is seen that fiscal policies are pro-cyclical in developing countries , a phenomenon dubbed as "when it rains it pours" by Kaminsky (2009). Unfortunately, for a democratic and federal country like India, the crisis deepens further because of the presence of political budget cycles (Sen & Vaidya;1996, Khemani;2004).

An important argument against the use of fiscal policy for the purpose of stabilisation is the issue of debt and its implication on growth. The Keynesian school of economic thought argues in favour of government debt as an outcome of government spending that is vital to boost up the economy. Governments raise debt to enhance public investment in both physical infrastructure and human resources. The degree of growth of gross fixed capital formation affects the level of government debt. During the current crisis, the debt to GDP ratio has increased considerably, breaching all ideal limits. According to Reinhart and Rogoff (2010 & 2012), there is no link between debt and growth when government debt is below 90% of the GDP. Thus, the adverse impact of debt on growth is not strong when the debt is not high.

Figure 1: Debt to GDP Ratios (2020)



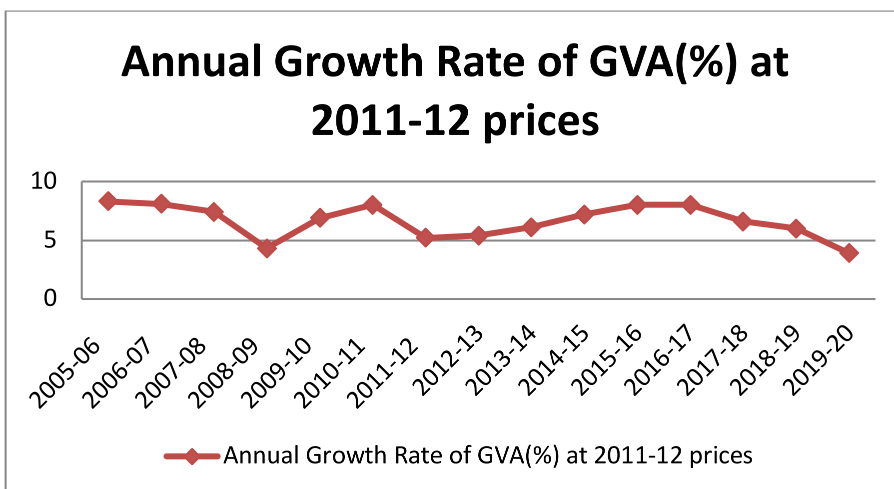
Source: Statista 2021

During 2020 and 2021, the debt to GDP ratio has scaled new heights (Figure1). Thus, preparedness for the future requires controlling this debt when the economy begins to embark upon revival.

SLOWDOWN TRENDS IN INDIA AND FISCAL POLICY

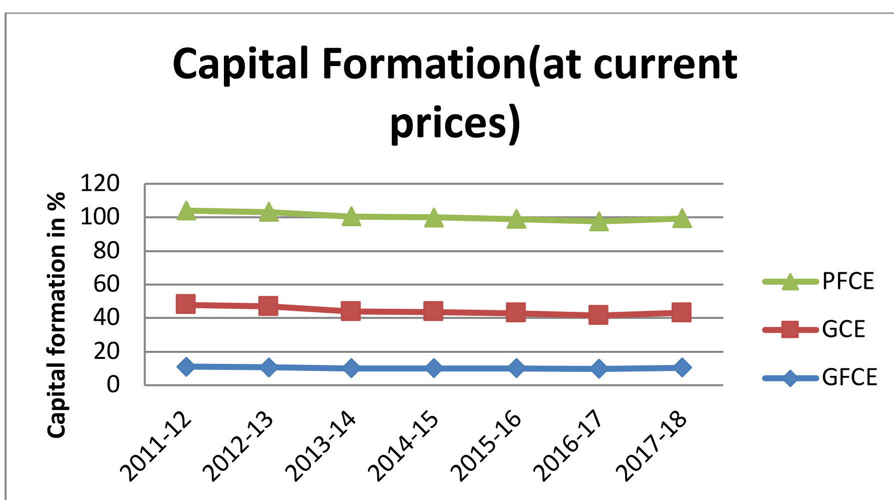
The Indian economic system has undergone major changes since the inception of economic reforms in 1991. The economy is more open and market-oriented as compared to the pre- reform era. As a result, it has now become more susceptible to slowdowns resulting from economic crises, which have their origin elsewhere. Moreover, the nature of business cycles has also changed drastically. Earlier, the crises were mostly monsoon driven but now they are more in tune with the economic crises happening in a market-oriented country. The current data shows that the Indian economy was struggling even prior to COVID-19 (Figure 2). The shocks to the economy due to demonetisation and GST implementation worsened the existing situation.

Figure 2: Annual Growth Rate of GVA at Constant Prices



Source: Handbook of Statistics by RBI

Figure 3: Capital Formation at current prices



Source: Handbook of Statistics by RBI

Total employment figures show a decline from 474.2 million to 465.1 million from 2011-12 to 2017-18 respectively, with a rise in unemployment rate by usual status from 2.2% to 3.1 % during the same period. Both savings rate and investment declined steadily between 2007-08 to 2017-18 (Table 1).

Table 1: Savings and Investment Rates as a Percentage of GDP (at current prices)

Year	Gross Savings rate	Gross Investment Rate

2007-08	38%	36.4%
2017-18	30%	29%

Source: National Accounts Statistics

For any economy to grow, high savings and investment rates are prerequisites. Such a decline in savings and investment rates has adversely impacted the Indian economy's potential output growth. Studies (S.Mahendra Dev & Sengupta, 2020; Subramanium & Feldman, 2019) point towards the fact that economic slowdown is because of structural, cyclical and global factors. The way out of this problem is to follow the Keynesian prescription in totality and not to become rigid with fiscal targets. Given the low interest rate scenario and poor demand for credit by the private sector, the public infrastructure investment would, in fact, help bring in private investment by creating the required demand in both urban and rural areas. Increase in domestic debt to finance-productive infrastructure will provide a big boost to the economy in the long run. Budgetary prudence may be resorted to once the economy is back on track; rise in private investment would help in the creation of jobs in the economy. Such a policy will not only help in the revival of the Indian economy but also tackle the twin issues of the unemployment crisis and the infrastructure shortfall.

The current pandemic has highlighted the importance of provision of merit goods. The pandemic, unrelenting and presenting new challenges before the world, has brought forth the realisation that the health sector cannot be left with only private players. Large scale funding is required and the overall upgradation of health infrastructure is a must. Regional variation due to differences in income will prove to be a big hurdle in the growth of the economy. No region can be sidelined without having repercussions for the entire economy.

Moreover, the requirement to bridge the digital divide among the rich and poor, thus ensuring equal opportunity for education for all again requires intervention and funding by the government. The pandemic has reiterated the fact that merit goods – education and health – cannot be left with the private sector alone. Any fiscal intervention means a role for the Discretionary Fiscal Policy (DFP) in the presence of fiscal rules. The countries across the board have realised that the government cannot withdraw from key sectors of the economy. The role of the government and of fiscal policy, has become more important and challenging. Thus, a new form of inclusive and interventionist capitalism is required. For a country with the second largest population in the world which has glaring inequalities (the richest 1% of Indians own 58.4% of wealth), the role of

the government and of discretionary fiscal policy has become more relevant. Understanding the importance of DFP brings us to another important component of fiscal policy -automatic stabilisers.

The talk about expenditure stabilisers affecting social sector in India started in the post-reform period, although India always had various unemployment, and poverty eradication programmes. Every ruling government started a new set of schemes or reinvented the existing programmes by merging them. The cyclical fluctuations seen today are also due to the integration of India with the world economy in a major way in the post-reform phase. Keeping the volatility in mind, the central government began another employment programme Mahatma Gandhi National Rural Employment Guarantee (MNREGA), previously known as NREGA, in 2005. This programme aims to provide the guarantee of 100 days of employment to households in rural areas. Over the years, the coverage of MNREGA has increased with budgetary allocation in the programme, increasing to 60,000 crores in 2019 -20.

In recent times, the central government has also started PM KISAN, a Direct Beneficiary Transfer (DBT) scheme, under which 6000 rupees is transferred to the accounts of farmers annually. Several states have launched schemes of their own as well. For instance, the KALIA (Krushak Assistance for Livelihood and Income Augmentation) scheme in Orissa, and RYTHU BANDHU in Telangana have begun in recent years. Under the KALIA scheme, the state government provides financial assistance of 10,000 rupees to all eligible and needy families of every small and marginal farmer for their crop and farming needs (5,000 each for kharif and rabi seasons). This targeted financial assistance will be provided for five cropping seasons spanning three years from 2018-19 to 2021-22. The government of Telangana state launched the Rythu Bandhu scheme for the development of the farmers of Telangana in the year 2018-2019 with a budgetary allocation of more than 12,000 crores. An incentive of 4000 rupees per acre of land is provided to all the farmers of Telangana under this scheme.

Recently, the Government of Delhi has started registering the construction workers in the capital. Around 2.7 lakhs out of a total 10 lakhs have registered. The government aims to provide productive jobs to these workers apart from other forms of social assistance.

Other than these schemes, there is no noticeable initiatives undertaken by other states. Although the central government has started various schemes related to the health sector such as Ayushman Bharat and insurance schemes like PM Jan Dhan Yojana, these schemes do not have the

capacity to act as automatic stabilisers. Almost all the schemes focus on the rural poor and the farmers, consequently leaving the urban poor exposed to the vicissitudes of business cycles. The current COVID-19 pandemic saw a reverse migration of enormous proportions. The workers from urban areas went back to their villages during the lockdown as they were left with no jobs and no rent to pay for their homes. With nothing left and having difficulty to provide even the basic necessities for their families, they returned to the solace of their villages hoping for some respite in the form of MNREGA jobs. Various empirical studies have shown that MNREGA has contributed to provide relief to the urban poor in stressful times (Table 2). It has even led to an increase in the average wages in rural areas.

Table 2: Employment Creation under the MNREGA Scheme

Employment Provided			
Months	**2019**	**2020**	**Increase**
April	273940403	141308625	-48%
May	369515900	568693697	54%
June	321428565	640708960	99%
July	194174791	391630385	102%
August	153052762	238976142	56%

Source: Ministry of Rural Development

As can be seen from the data (Table 2), the reverse migration resulting from the pandemic caused the number of job seekers to rise significantly from May 2020 to August 2020. This led to an increase in employment provided under the MNREGA scheme in rural India. This human tragedy demands strong expenditure stabilisers for the urban poor in India on lines similar to those of MNREGA. The next section will suggest one such option of designing such a programme in urban areas.

AFS in Urban India

India's GDP growth saw a decline by 23.9% in the real gross domestic product (GDP) during the first quarter of 2021 (April, May, June). However, the data also shows that economic slowdown was happening even before the COVID-19 crisis (GDP growth in the fourth quarter of FY 2019-20 fell to 3.1% from 4.1% in the third quarter). The major reasons were structural problems which requires solution. Structural reforms (including on the fiscal side) are needed to deal with these long-

term or permanent shocks. Other than the long-term or permanent shocks, where automatic stabilisers may lead to an increase in government debt and bring risks to fiscal sustainability, India needs to remain prepared for huge economic fluctuations on three different counts:

1) **Business Cycle**

The global economy has experienced 18 recessions of various degrees since 1870. The contraction in GDP, as a result of the global recessions, varied from -17.6% to -0.8%. India too, has started to experience market-linked recessions. As per the Reserve Bank of India (RBI)[3], since independence, India has witnessed four recessions. The recessions occurred in 1958, 1966, 1973 and 1980. These recessions saw contractions of -1.2% (FY58), -3.66% (FY66), -0.32% (FY73) and -5.2% (FY80). Weak monsoons and the energy crises were the main reasons for these contractions in India's GDP. India entered a "technical recession" in the first half of 2020-21(fall in GDP for two consecutive quarters) with 23.9% and 8.6% contraction in GDP growth in first and second quarters of FY 20-21 respectively. Even during the Global Financial Crisis of 2008, both China and India did not experience a recession, but rather experienced a milder counterpart called a slowdown (Dua & Banerji, 2009), meaning a downshift in the pace of positive growth in economic activity. A recession, on the other hand, is much more severe, resulting in a cycle of marked and persistent cascading declines in output, income, employment, and sales. With increased globalization and strong global interdependence of the Indian economy in terms of both financial and trade linkages, India cannot escape the impact of global recessions.

2) **Pandemics**

The current pandemic is considered to be similar to the Spanish flu in impact but the havoc and deaths caused by it has surpassed even the most deadly flu faced by the modern world. Since then, many pandemics have affected the world economy but not to the extent of COVID-19.This also means that our health care system should remain prepared for similar pandemics in future. This requires large scale funding in research and development. A pandemic as severe as COVID-19, can bring even the well-functioning economies to a standstill. The private sector cannot respond efficiently to such problems without intervention by the government. Therefore, the Indian government should not think of withdrawing from the basic public and merit goods; the education and health sectors.

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[3] Source: RBI Bulletin November 2020

3) **Unemployment due to advance of Artificial Intelligence (AI) and machine learning**

Countries mostly concentrate on the first reason for economic fluctuation with regards to being prepared. However, before the COVID-19 pandemic, there was talk about how jobs would be transformed with advances in artificial intelligence and with the advent of robots for routine tasks. This would lead to the emergence of new jobs for skilled professionals and creative personnel, leaving masses in lurch. By one estimate, 40% of all the jobs created will require AI skills; the percentage will keep on increasing with time (McKinsey; 2017). This would also have enormous consequences for a labour surplus economy such as India.

Therefore, India needs to be prepared to deal with situations arising from all three counts. On one hand, relevant skills must be taught to its population and on the other hand, strong automatic stabilisers must be developed in both urban and rural areas.

To design an automatic stabiliser for urban areas:

1) Registration

The Indian government (central and states combined) should register all urban poor with complete details about their education, employment status, place of residence, gender and age. A unique stabiliser number may be created which can be linked to their Aadhar cards.

2) Infrastructure-based AFS

All existing and potential infrastructure programmes may be listed along with their requirements and their benefits to the economy, expenditure details, ability to create jobs. During times of recessions, elasticity estimates are very high for public expenditure whereas the value is low during booms when public investment actually crowds out private investment. The overall multiplier effects of expenditure stabilisers will help keep the economy afloat during slowdowns.

The infrastructure sector with its strong linkage with the development of economies has attracted much renewed interest from policy-makers in current years. The IMF report points towards the potential of infrastructure being part of counter-cyclical measures (International Monetary Fund, 2014; Asian Development Bank, 2017; Fay & Rozenburg: Beyond the Gap, 2019). Several studies have also focussed on the impact of infrastructure investment on economic growth supply-side capacity and unemployment (Aschauer, 1990; Calderon & Serven, 2004; Allcott,

Collard-Wexler, & D O'Connell, 2016). Canning and Pedroni (2004) investigated the long run impact of infrastructure provision on per capita income in a panel of countries over the period 1950-1992. The results provide clear evidence of infrastructure- induced long run growth effects. A recent study by Han, Su and Thia (2020) emphasised that the share of gross capital formation devoted to infrastructure should be higher in developing economies as increasing infrastructure per worker has a larger relative impact on developing economies.

3) Counter-cyclical Fund

The creation of a countercyclical fund is a requirement that no country, including India, can ignore. The governments in emerging economies need to think seriously about setting up counter-cyclical funds to hedge their economies from frequent cyclical changes and shocks. These funds should be part of a wider macro-prudential policy framework acting as a buffering mechanism. Money received from disinvestment proceeds and asset monetisation such as giving unused railway land on lease, could help build these funds. The Indian government is undertaking asset monetisation on a large scale. The money thus acquired should not be spent on achieving political gains, and if required a Countercyclical fund (CCF cess) can also be levied. The receipts from disinvestment proceeds, asset monetisation, and (if required) cess during booms can all be used to maintain this counter-cyclical fund. This fund can be designed and calibrated in a manner so as to act as a shock absorber for the Indian economy. The government began a Make in India programme in the year 2014 when the share of manufacturing (expressed as percentage of GDP) was 16-17%, with the target to increase this share to 25% of GDP by 2025. Now, along with Make in India, the government is emphasising Atmanirbhar Bharat in the expectation that the ripple effect of localisation will result in the creation of jobs and a subsequent reduction in dependence on imports. The government has also started the Production Linked Initiative (PLI) scheme, where the government will pump in 1.97 lakh crore rupees over the next five years in thirteen selected sectors to incentivise manufacturing. India can benefit from all these schemes only when it possesses sufficiently skilled and trained manpower. Otherwise, it will be a precarious situation with a lack of skilled workers to meet increasing demand of labour and a large number of unemployed unskilled workers who would continue to be dependent on state support. Therefore, a major initiative should be undertaken to skill and train our youth at the college level instead of churning out unemployable graduates every year.

WORD OF CAUTION

Undoubtedly, investment in infrastructure has its advantages in the form of strong linkages with the rest of the productive sectors. It also acts as an inducement to invest in any economy. Good overall infrastructure-communication, transport, electricity, water and roads - all have the potential to attract private and foreign investment. Infrastructure also requires labour which results in the generation of productive employment. Unfortunately, the Indian experience has shown that infrastructure projects generally do not finish on time, thus resulting in increased project cost to the extent of rendering the projects financially unviable. The real estate sector witnessed a boom beginning in the 2000s. Companies started taking loans from not just banks but from Non Banking Financial Corporation's (NBFCs) as well. In the absence of effective regulators, these companies kept diverting their funds from one project to another without completing any of them. The result was a rise in Non Performing Assets (NPAs) of banks and Non Banking Financial Companies (NBFCs). What started with a twin balance sheet problem has now translated into a four balance sheet problem (Subramaniam & Feldman; 2019).

Therefore, infrastructure projects need to be time-bound and require regulation with penalty clauses. While the infrastructure sector has the ability to generate employment and help the economy to absorb cyclical shocks, care must be taken while designing policies for its involvement.

CONCLUSION

The role of the government will become increasingly important in times to come with fiscal policy playing an important part in the stabilisation of the economy. The Global Financial Crisis of 2008 and the COVID-19 pandemic have again outlined the importance of fiscal policy. The problems associated with discretionary fiscal policy related to time lags have not impacted economies as expected. However, the fiscal deficit and debt are something that governments cannot ignore. Therefore, it is very important to ensure that governments follow counter-cyclical fiscal policies not only during slowdowns but also during booms. It has been observed that monetary policies have their limitations and effective time lags involved are not insignificant. Therefore, governments all over the world are returning to a dependence on fiscal policy. The importance of a strong social security net has been realised during the human catastrophe unleashed by COVID-19. The assumption that the global situation will return to its pre-pandemic state must not engender complacency; preparation for shocks is an absolute must. Strengthening the health-care system and embracing sustainable development will help India tackle future crises. Shocks to the economy may also happen due to climate change; a recent avalanche in Uttarakhand's Chamoli district that destroyed the Tapovan project highlights the fact that nature cannot be

ignored. India needs to walk on a tightrope because it has many simultaneous precarious problems: unwanted strife with neighbouring countries, environmental concerns, large population, and the inability of the manufacturing sector to create enough jobs leading to a subsequent increased pressure on the agriculture sector. Economic reform is essential as is obtaining FDI in order to boost production but the government cannot withdraw from key areas and leave the masses to the vulnerabilities associated with private ownership. To remain prepared for any adverse situation, the Indian government needs to build a strong set of expenditure stabilisers for the urban poor, as outlined in this paper.

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