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Fiscal Policy and Its Effectiveness in the Nepalese Economy

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Abstract

Fiscal policy is one of the most important policies to manage the demand side of the economy. Like other policies, the primary objectives of fiscal policy to attain the macro economic goal or objectives such as equity, stability, full employment, favorable balance of payment and so on. Major instruments of fiscal policy are taxation and government expenditure. Government budget is the medium through which these instruments are implemented. These instruments first affect the aggregate demand and then real sector variables such as income, employment, output, price level, and so on. But in the Nepalese case, like other policies, fiscal policy has not been able to achieve its goals or objectives. Poverty has been accelerating; foreign dependency has further increased, the country has listed one of the poorest countries. These all shows the failure of fiscal policy to achieve its goals or objectives. This paper has made an attempt to overview the impact of fiscal policy in terms of some indicators such as price level, economic growth and equity.

Meaning of Fiscal Policy:

Fiscal policy has been a topic of scholarly dispute and public discussion since the Keynesian revolution of the 1930s. It may be defined as the policy to regulate aggregate economic activities by using fiscal instruments. Such regulation is directed towards the achievement of macro economic goals or objectives such as high economic growth rate, full employment, price stability, equity, favorable balance of payment, etc. The instruments used to attain these goals, known as instruments of fiscal policy is taxation, government expenditure, government borrowing, government purchase of the goods and services, subsidies, transfer of payment, public works, etc (Weil, 2003).

Fiscal policy may be defined in another way also. It is the use of the government budget to affect an economy. When the government decides on the taxes that it collects, the transfer payments it gives out, or the goods and services that it purchases, it is engaging in fiscal

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policy. Discussions of fiscal policy, however, usually focus on the effect of changes in the government budget on the overall economy—on such macroeconomic variables as GDP and unemployment and inflation.

The most immediate impact of fiscal policy is to change the aggregate demand for goods and services. A fiscal expansion, for example, raises aggregate demand through one of the following channels (Weil, 2003).

a. First, if the government increases purchases but keeps taxes the same, it increases demand directly.

b. Second, if the government cuts taxes or increases transfer payments, people's disposable income rises, and they will spend more on consumption. This rise in consumption will, in turn, raise aggregate demand.

c. Thirdly, taxes and transfers affect incentives to work, incentives to save or, invest, which ultimately affect aggregate demand through the effect on out put, income.

During the classical and neo-classical period, there was no scope of fiscal policy. The importance of fiscal policy was realized after the Great Depression of 1930s. During the great depression, private investment declined, millions of industries closed down, trading decreased drastically and unemployment soared up dangerously and the economy of west in particularly contracted miserably. This situation gave rise Keynesianism, which strongly preferred the active role of government to keep the economy out of the depth of depression. They strongly recommended increasing the government expenditure even by using the budgetary deficit to revive the economy.

But in the decade of 1950s, with the failure of Keynesianism and emergence of Liberal regime, the importance of fiscal policy has decreased substantially. In the regime of economic liberalization, government interventions in economic activities are not desirable. Private sectors are encouraged to play leading role in the economy. Like wise, since the liberal economic regime requires the macro economic stability, government budgetary deficit is strictly controlled in order to maintain the stability. This has substantially reduced the importance of fiscal policy. Similarly, liberal economic regime demands the low and few tax rates, no tax incentives, and no protective tariff wall for the domestic industries.

However the economic crisis of ASEAN countries in 1997 showed that weak governments in the economic matters do not guarantee the sustainability of the economic growth. Private sector involves only on profitability activities and it is prone to the trade cycle and external shocks. And the government should come forward to rescue the economy. The only solution of the economies passing through the recession is increasing the volume of investment to the socially desirable sector. Private sector as being profit oriented would not interest to invest on the socially desirable sector. In this time, government has to play leading role in the economic activities. This has maintained the importance of fiscal policy even in the liberal economic regime.

Instrument of Fiscal Policy

Fiscal policy is the interaction between government expenditure and taxation. This is because on the one hand, by the means of taxation, it diverts the resources from public to government and on the other, by the means of government expenditures; it diverts the resources from government to public. In order to perform it, it uses the following tools or instruments (Sharp & Sliger, 1970).

1. Taxation;
2. Government expenditure;
3. Public borrowing;
4. Money creation;
4. Public work.

These instruments first affect aggregate demand and then real sector variables such as income, employment, output, and so on. When tax rate is reduced, it increases the purchasing power of the public, which increases the aggregate demand. Similarly, when government expenditure is increased, money in the hand of public increases, which increases aggregate demand. Like wise, public borrowing involves the transfer of purchasing power from the individuals and companies. Borrowing from households and companies reduces their liquidity and hence aggregate demand in the economy. Modern version of money creation is the borrowing from the central bank. When borrowing from central bank increases, it reduces the volume of credit available to private sector and vice-versa. Similarly, by the generation of various public works, aggregate demand can be raised and enhanced in the economy. In sum, these instruments first affect aggregate demand. When aggregate demand is affected, we can realize the goals or objectives of fiscal policy.

Objectives of Fiscal Policy

In the developing countries, the major objectives of fiscal policy are as follows (Margrave & Margrave, 1989)

- *Attainment of greater economic stability*: Greater economic stability implies – high growth rate, low population growth rate, and low people below poverty line.
- *Full employment*: Full employment is the situation in which demand for labor is constantly in excess of supply at prevailing prices.
- *Stability of general price level*: Stability in general price level means the situation in which there is no inflation and deflation. But Philips curve shows the trade - off relationship between unemployment and inflation. So we have to accept some degree inflation at the initial stage of economic development. Hence price stability means a moderate rate of inflation.
- *Equitable*: Equity means equitable distribution of income and wealth, through which we can alleviate poverty.

These objectives are not always compatible, particularly price stability and full

employment. The objective of equitable distribution of income may come in conflict with the objective of economic growth. Fiscal policy may transfer wealth from rich to poor through the use of taxation with a view to bring about a redistribution of income, but it may be criticized on the ground that it will affect saving and capital formation, which in turn affect investment and hence employment. Fiscal policy as a means for influencing the flow of income may involve either a change in level of taxes or a change in the level of expenditure or both. Whatever method is adopted, the basic consequences are the same.

Fiscal Policy and Its Effectiveness in Nepalese Context

Like other countries, Fiscal policy in Nepal has been formulated and is being implemented in order to achieve the above-mentioned objectives. Theoretically, we can achieve various objectives of fiscal policy but in practice, these objectives are constrained by various factors such as socio-economic, geo – physical and political factors. It is successful to achieve some objectives and unsuccessful to achieve some objectives. In term of objectives, our fiscal policy is comparatively successful to achieve the stability objective and completely unsuccessful to achieve the equity or redistribution objectives. Let us examine the effectiveness of fiscal policy objective-wise.

1. Impact of Fiscal Policy on Stability: Historically, Nepal's fiscal policy seems to have achieved the stability objectives in comparison to other objectives. This is because National Urban Price Index, a proxy measures to the over all macro economic stability has never gone above two digits. The highest rate of inflation was 21.1 in 1991/92 and that was not due to fiscal reason. It was on account of the massive upward revision of the charges and prices of the goods and services produces and supplied by the government. Another major indicator of stability is the balance of payment position, which has not been the matter of problem for Nepal. It has never been persistently adverse to Nepal. Out of 25 years, only in 6 years, Nepal has experienced the adverse situation in balance of payment. And in other years, it is positive. Even in the years in which there was huge balance of payment surplus, the inflation rate was as lower as of 4.0 percent in 1997/98. From 1982/83 to 1984/85, government had adopted the expansionary fiscal policy. Government had borrowed heavily to finance the deficit. Even during that period, inflation rate was low and there was little deficit in balance of payment. The reason is that increased aggregate demand being met by import. That is why; there is no pressure in the price level.

Fiscal Policy and Stability

FY	Budget Deficit as % of GDP	Overdraft as % of GDP	BOP Surplus (Rs. in Million)	Annual Rate of Inflation (%)
1974/75	1.3	-	355.2	16.7
1975/76	2.5	-	358.2	-0.6
1976/77	3.6	-	628.2	2.6
1977/78	3.2	-	10.8	11.3
1978/79	2.7	-	583.4	3.4
1979/80	3.4	-	26.4	9.7
1980/81	2.9	-	193.3	13.4
1981/82	5.4	-	262.1	10.5
1982/83	9.0	-	-671.7	14.2
1983/84	8.0	0.5	-126.0	-
1984/85	8.0	0.2	-866.0	4.1
1985/86	7.5	0.4	563.0	15.9
1986/87	7.0	0.1	376.5	13.3
1987/88	6.4	-	-2273.0	11.1
1988/89	10.0	2.4	75.9	8.1
1989/90	8.4	0.4	2649.6	9.7
1990/91	9.2	-	4132.2	9.8
1991/92	7.8	0.4	3394.4	21.1
1992/93	7.2	2.0	7740.2	8.8
1993/94	6.1	0.4	6283.3	9.0
1994/95	5.0	0.4	-313.9	7.6
1995/96	5.8	1.0	-1080.5	8.1
1996/97	5.3	-	3202.1	7.8
1997/98	6.2	0.8	10965.9	4.0
1998/99	6.1	0.3	9838.4	11.4
1999/00	4.8	0.1	14448.6	3.5
2000/01	6.1	1.7	5221.4	2.4
2001/02	5.6	-	-3342.9	2.9
2002/03	3.7	-	-	3.6

Source: 1. Economic Survey, 2004/05, MOF
2. Budget Speech, 2004/05, MOF

The table depicts the major indicators of macro economic stability such as annual rate of inflation, balance of payment position, budget deficit as the percentage of GDP and over draft as the percentage of GDP. It is obvious from the table that the balance of payment position has remained favorable except in 6 different years out of 29 years. Similarly inflation rate is also low and remained below 22 percent. In FY 1988/89, there was huge budget deficit as 10 percent of GDP but balance of payment had turned positive from negative and price level had declined from 11.10 percent to 8.10 percent. Similarly, in FY 1992/93, there was record of balance of payment surplus and price level had declined from record of high level of 21.10 percent to 8.8 percent.

2. Impact of Fiscal Policy on Growth: Theoretically fiscal policy is conductive to economic growth. Whenever expansionary fiscal policy is used, it increases AD, which increases income, employment and output. Let us take some indicators such as GDP growth rate, revenue - GDP ratio, revenue surplus - development expenditure ratio and ratio of outstanding foreign loan to GDP to assess the impact of fiscal policy on growth.

Fiscal Policy and Economic Growth

Fiscal Year	GDP Growth Rate (%)	Revenue–GDP Ratio (%)	Revenue Surplus -Development Expenditure Ratio(%)	Outstanding Foreign Loan -GDP Ratio (%)
1974/75	-	6.1	47.8	2.1
1975/76	4.4	6.4	35.6	2.7
1976/77	3.0	7.7	32.8	3.6
1977/78	4.4	8.0	26.7	4.9
1978/79	2.4	8.2	38.9	5.9
1979/80	-2.3	8.1	31.0	7.7
1980/81	8.3	8.9	38.7	9.0
1981/82	3.8	8.6	28.0	10.3
1982/83	-3.0	8.4	18.6	14.0
1983/84	9.7	8.7	22.0	16.0
1984/85	-	8.8	18.4	20.7
1985/86	4.7	8.7	17.1	19.4
1986/87	2.0	9.8	24.9	24.8
1987/88	7.0	10.0	28.4	28.5
1988/89	5.4	9.1	17.0	34.0

Contd....

1989/90	4.9	9.3	20.0	36.9
1990/91	6.4	9.2	19.8	51.2
1991/92	4.6	9.3	21.8	48.9
1992/93	3.3	9.2	18.9	52.9
1993/94	7.9	10.2	33.8	53.2
1994/95	2.9	11.7	26.8	53.8
1995/96	5.7	11.6	25.3	53.5
1996/97	4.8	11.3	24.6	49.0
1997/98	3.4	11.4	19.9	56.4
1998/99	4.5	11.3	21.7	53.8
1999/00	6.4	11.7	26.4	52.2
2000/01	5.8	12.5	15.5	50.0
2001/02	-0.3	12.0	5.9	54.27
2002/03	2.7	12.4	4.3	51.31

Source: 1. Economic Survey, 2004/05, MOF, Kathmandu
2. Budget Speech, 2004/05, MOF, Kathmandu.

The table shows that none of the above mentioned indicators have sustained growth trend. GDP growth rates have wide fluctuation and that also between low ranges. Revenue-GDP ratio is very low on the one hand and progress is quite slow and it is also un-sustained on the other. The contribution of revenue surplus to development expenditure is very low as 4.3 percent of GDP in 2002/3. This implies that about almost all development expenditure is being financed by foreign grants and borrowing. Similarly the outstanding foreign loan GDP ratio has increased from 2.1 percent in FY1974/75 to 56.4 percent in FY1997/98. If fiscal policy were contribute to growth, GDP growth rate would be sustained and in upward trend; revenue-GDP ratio would increase, revenue surplus-development expenditure ratio would be increased and outstanding foreign loan-GDP ratio would be decreased. But in Nepalese case, these indicators do not justify that fiscal policy is so much effective to contribute economic growth.

3. Impact of Fiscal Policy on Equity: Theoretically, fiscal policy can be used to achieve the equity or for redistribution of income and wealth. In order to achieve the equity objectives, the contribution of direct tax should be significant and should be increased. But in case of Nepal, contribution of direct tax is very low as of 25 percent of total tax revenue and that of indirect tax is around 75 percent of total tax revenue in FY 2001/02 (MOF, 2003). Direct tax is completely failure to mobilize the resources. Income tax revenue, which is just 1.5 percent of GDP, is one of the lowest in the world (MOF, 2003). Wealth tax was introduced in 1990/91 but it was virtually withdrawn in 1994/95 due to the strong

opposition and resistance of the taxpayers. This shows that taxation has not been able to redistribute the income and wealth.

On the expenditure side of fiscal policy, there are certain areas in which budgetary allocation has been made to support the poor. These are school education and primary health, subsidies to bank credit, old age pension, old age allowances, disabled and widow allowances, etc. But these provisions have not been able to bring remarked-able results. Majority of population are still below the absolute poverty line. Income and wealth are concentrate on limited number of people. Human development indicator is very weak and the country is ranking at 143th position out of 175 countries in 2003 (UNDP, 2004). Thus, the socio-economic information does not give any indication of improved scenario of income and wealth redistribution in the country.

Conclusion

Fiscal policy in Nepal has failed measurably to achieve its goals whether it is growth or equity. In case of stability, the long open and unregulated border between India and Nepal has neutralized the expansionary effect of fiscal policy. Whenever aggregate demand increases by the means of fiscal expansion, it is met from import. As a result, there is no pressure in price level. Hence although price stability has been maintained, it is not due to the fiscal reason rather it is due to the geo – physical situation of Nepal.

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