

# Study of the Active Fiscal Policy under the New Normal

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**Abstract.** In the process of formulating fiscal policy, China has adopted active fiscal policy twice. In 1998, the government adopted active fiscal policy for the first time to resist the negative impact of the Asian financial crisis. In the second half of 2008, the central government announced that its fiscal policy in order to fend off the negative impact of the subprime mortgage crisis in the United States had changed from prudent to positive. However, China's active fiscal policy has focused on infrastructure development over the years. This approach to development is very effective in stimulating economic growth in the short term, but it will have a series of negative consequences for long-term development. Based on the connotation, effectiveness, limiting factors, suggestions and theoretical research results of active fiscal policy, this paper combs and summarizes the current active fiscal policy.

**Keywords:** Active fiscal; Financial policy risk; New normal.

## 1. Introduction

In 2007, the subprime crisis occurred in the United States, which eventually evolved into the financial crisis of Wall Street and quickly spread to the whole world. In this context, in the second half of 2008, the central government announced a new round of active fiscal policy from prudent to positive. Early on, it did make an important contribution to economic recovery. Since March 2009, the GDP growth rate has maintained a continuous upward trend for four consecutive quarters. By March 2010, the growth rate had climbed to 11.9%, exceeding the target of maintaining the growth rate of 8% and maintaining the GDP growth rate of over 9% in 2011. However, since 2012, the GDP growth rate began to decline year by year, with the average annual growth rate of less than 8% in 2012 and even less than 7% in 2015 and 2016. At the same time when public confidence in China's economy is low, the party central committee has put forward a concept that is consistent with China's economic development -- the new normal.

Under the new normal of the economy, the central government decided to continue to implement the active fiscal policy. Over the years, China's active fiscal policy is based on Keynes's theory of demand management, and the main idea of this theory is to promote rapid economic recovery in the short time by large scale infrastructure construction. However, the implementation of macroeconomic policy is not static, it must adapt to the specific economic situation. And it will bring a series of adverse consequences for long-term development, such as excess production capacity, increased government debt ratio and waste of resources. One of the important tools of national macro-control is active policy. At present, China's economic development is in a transition stage from high speed to high quality. The active fiscal policy currently implemented in China has distinct Chinese characteristics. Only by grasping its connotation and development mode well and knowing the factors that restrict the policy can fiscal policy play a full role in national governance.

## 2. Theoretical Basis

### 2.1 The Theoretical Basis of Active Fiscal Policy

The theory of active fiscal policy originated from the economist Keynes's theory of macroeconomics, and Keynes' economic policy is widely debated. Keynesian economists believe that the capitalist system is flawed, that government intervention can reduce the consequences of this defect, and that when economic growth slows, the government can use expansionary fiscal policies to stimulate demand growth. Some economists oppose this theory. They argue that Keynesian

economic policies do not work well in an economic crisis, because government is not a money-making sector and cannot be created from nothing. Saving the economy requires a real understanding of how markets work and entrepreneurial innovation.

## **2.2 The New Normal**

The term "new normal" was formally applied to the economy at the World Economic Forum in 2010, when Mohamed A. El-Erian, an American investment banker, summed up the global economic malaise and low growth that followed the 2008 US financial crisis. After that, the concept of "new normal" began to be widely accepted by people, and the frequency of media usage increased significantly.

In November 2014, at the APEC CEO forum, the three major characteristics of China's economic development under the "new normal" -- speed change, structural optimization and transformation of driving force -- were systematically expounded for the first time, and the huge opportunities and challenges China faces under the "new normal". Since then, the Chinese version of the new normal has been formally put forward, and quickly became a hot word in the social discussion.

The important background of the new normal is that China's economic development is faced with the characteristics of "three overlapping periods". The so-called "three overlapping periods" refers to the period of economic growth rate change, structural adjustment and adjustment of early stimulus policies. It is precisely based on the "three overlapping periods" and the deep adjustment of the world economy that complicate the internal and external environment of China's economic development, the Party Central Committee has made the strategic judgment that China's economy has entered the new normal.

## **3. The Connotation and Effect of China's Active Fiscal Policy**

### **3.1 The Connotation of China's Active Fiscal Policy**

In the process of implementing fiscal policy in recent years, the academic circle equates China's active fiscal policy with national debt policy. From the beginning, the main implementation content of China's active fiscal policy is to increase fiscal expenditure and internal demand by issuing additional treasury bonds to achieve further economic growth. China's proactive fiscal policies are different from those in the west. Although they are essentially expansionary fiscal policies, China has not implemented tax reduction policies similar to those in the west. Instead, it has strengthened tax regulation and focused on optimizing the structure of expenditure. The main measure is to increase government investment by issuing more bonds to strengthen infrastructure.

### **3.2 The Effect of China's Active Fiscal Policy**

#### **3.2.1 The First Round of Active Fiscal Policy**

The first round, due to the impact of the Asian financial crisis in 1998, led to reduced demand for exports, reduced investment by foreign enterprises, and insufficient effective demand, which slowed economic growth and the use of monetary policy was already too intensive at that time. Therefore, between 1998 and 2004, China has taken active fiscal policy measures such as resisting the impact of the Asian economic crisis, adopting export tax rebates, and encouraging investment to overcome the Asian financial crisis, and achieved an economic growth of 8% at that time. Between 1998 and 2004, the GDP growth rate has steadily increased; The growth rate of total retail sales of social consumer goods rose from 6.8% to 25%. The growth rate of export commodities was also between 6.1% and 31.7%. The data shows that positive fiscal policies have had a positive impact on the Chinese economy.

#### **3.2.2 Second Round of Active Fiscal Policy**

Second round was due to America's subprime crisis. Investment consumption and exports in 2008 were affected and there was a significant reduction. In response to this crisis, China implemented a basket of 4 trillion programs in 2009 to stimulate consumption and investment. The main purpose of

the second round of active fiscal policy in 2009 is still to expand domestic demand. The main role of the planned 4 trillion is to improve infrastructure. In the two subsequent policy changes, funding for social security, education and livelihood projects increased and investment in infrastructure decreased. With the implementation of the second round of active fiscal policy, the GDP growth rate reached 9.2 % in 2009, 10.3 % in 2010 and 9.3 % in 2011, and consumer demand has gradually increased. Since 2009, China's total retail sales of consumer goods have maintained a growth rate of over 14 percent. After the 4 trillion investment plan was implemented, China's investment in fixed assets has grown significantly.

Two rounds of active fiscal policy have significantly boosted economic growth.

### 3.2.3 Current Active Fiscal Policy Effect

In 2018, the active fiscal policy performed better. For example, the reduction of value-added tax rates and other tax cuts in the manufacturing, transportation and other industries is expected to reduce the burden on market players by about 1.3 trillion yuan this year. The size of the tax cuts and their share of GDP are among the largest in the world. In 2018, fiscal expenditure increased by 8.7% year on year, and maintained a relatively high intensity and relatively fast pace, strongly supporting the implementation of major national strategies and reform in key areas.

### 3.3 Limiting Factors

Since the implementation of active fiscal policy, there are two major problems worth noting. Since the implementation of the active fiscal policy in 1998, the rapid growth of the Chinese economy has largely benefited from investment in fixed assets. According to the data, the proportion of fixed assets invested in GDP is increasing every year, even as high as 69.6% in 2012. This situation will lead to an imbalance in the industrial structure. The secondary industry has become one of the main forces driving economic growth, and the tertiary industry has a lower contribution to GDP.

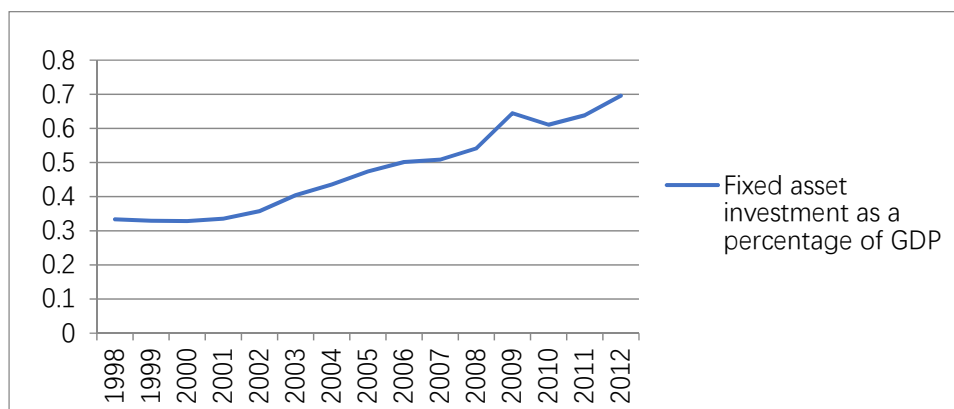


Fig 1. Fixed asset investment as a percentage of GDP

Moreover, the long-term deficit of government finances will increase the government debt burden and may lead to a financial crisis. The data shows that since the implementation of active policies in 1998, in the 15 years to 2012, except for the fiscal surplus in 2007, the rest of the years are in fiscal deficits.

The effect of direct investment in fixed assets is regressive rather than indirect promotion of private investment and consumer demand. This growth method is not optimal. Although this growth method has accumulated some high-quality state-owned assets, it has also brought 660 billion yuan of debt related to active fiscal policy, and the expansion of fiscal spending will hinder further economic growth. The implementation of active fiscal policies may lead to deficit risks, which in turn will affect the effectiveness of policy implementation. Some of the infrastructure investments made by the Government are inefficient, affecting the objectives of active fiscal policy.

Through the analysis, it is concluded that the unreasonable distribution of income and the unpredictable nature of the changes in the system are the important reasons why the increase in

income can't not drive consumption, so that the increase in fiscal expenditure can not effectively drive consumption.

The implementation of the active fiscal policy requires a large amount of financial input from the government. However, the current way of raising financial funds in China is relatively traditional and single, lacking diversity and innovation, so it is difficult to meet the demand of future public fiscal expenditure. The Chinese government mainly raises funds through public revenue, local financing platform companies, domestic and foreign loans and other self-raised funds. However, in view of the current situation, the mode of financing mainly relying on public financial revenue and financing platform companies is no longer sustainable, and there is an urgent need to innovate and enrich government financing methods.

#### 4. Conclusion

Based on the experience of foreign countries such as Obama's economic revitalization plan, the EU's joint response strategy and Russia's prudent fiscal policy, three experiences are summarized.

First, we should guard against the continuous use of active fiscal policies. Although it is necessary to use positive fiscal policies to stimulate economic growth in the short term, in the medium and long term, the policy effect is not always more positive than negative. The expansionary fiscal policy will increase the risk of fiscal deficits. The red line of the international fiscal deficit rate is 3 %, so that fiscal policy is predictable and preventive.

Second, we need to adjust the structure of fiscal revenue and expenditure and optimize the economic structure. In order to optimize the economic structure, we need to adjust the structure of fiscal revenue and expenditure, promote the development of the service industry, increase expenditure on people's livelihood, and substantially expand domestic demand and promote consumption. From 1998 to 2008, expansionary fiscal policies relied too much on fiscal spending to achieve results. In order to achieve better results for active fiscal policy, optimizing the balance of income and expenditure structure is the key. First of all, we must shift the focus of work from spending to income, and we must attach importance to the optimization of tax cuts and fees in order to maintain a sustained increase in growth. Starting from the income side, we will optimize the implementation environment of active fiscal policies, such as tax adjustment, social security system reform, rural reform, and tax and fees reform. From the point of view of expenditure, the role of fiscal expenditure after entering the new normal is increasingly important, and the implementation should be within the scope of fiscal risk control, not without a ceiling. The expenditure structure should also be optimized, and the efficiency of the use of funds should be improved, such as supporting innovation and scientific and technological development, increasing expenditure on people's livelihood and education, and reducing administrative and other miscellaneous expenditures, so as to put the money to good use. To allocate fiscal policy resources, we need to focus on the use of funds, for example, in areas such as innovative activities with significant externalities, social undertakings that are conducive to narrowing the gap between urban and rural areas, and social undertakings that have a bearing on people's well-being.

Vigorously promoting the government and social capital cooperation models, the new normal, on the one hand, the government spending to increase rigidity, provide public products and services, on the other hand to reduce the enterprise the management cost, but also control the scale of fiscal deficit and how to use the limited financial capital to do more things. That requires that the government cannot be confined to the traditional financial financing means. We should innovate the way of providing public goods and services, and shift from the past government to the PPP model that relies more on cooperation between the government and private capital. PPP model levers more social capital with limited government funds to participate in the provision of public goods and services, which can not only effectively solve the dilemma of insufficient government financial resources under the new normal background, but also help promote the transformation of government functions.

Third, adjust the relationship between the government and the market, strengthen the supervision of money market, and create a good external environment for the implementation of fiscal policy.

Active fiscal policy and market-oriented reforms should be coordinated to integrate short-term policies with long-term reform plans and jointly help the development of the economy. Open up the policy implementation path, so that the policy can really be implemented on the beneficiaries, and to reduce idle funds, to avoid unreasonable budgetary arrangements lead to the precipitation of funds, reduce the efficiency of the use of funds, to strengthen the binding force of the rule of law on fiscal behavior.

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