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The Impact of Fiscal Policies on Corporate **Investment Strategies and Stock Market Performance**

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Abstract

This paper examines the relationship between fiscal policies and their impact on the private sector and stock market fluctuation particularly focusing on the difference in the reaction between developed and developing countries. It is based on secondary data focusing on case studies of key policy movements in recent years and their impact on the private sector and financial market. This included utilizing published data, academic journals, government economic reports, stock market performance indices, and corporate financial statements. The findings indicate a significant relationship between fiscal policies, both through tax policy changes and government expenditure, on corporate investment decisions. However, this relationship is also affected by factors like market conditions, economic growth, etc. Similarly, significant stock market volatility has been observed post-fiscal policy announcements. Other factors affecting stock market performance include investor's psychology, long-term predictions, etc. Notably, developed economies generally observe fewer fluctuations after fiscal policy announcements and implementation as compared to emerging economies.

Keywords: Fiscal policy, private sector impact, stock market fluctuations, developed vs developing economies, corporate investment decisions, tax policy changes, government expenditure, investor psychology, economic growth, market volatility.

1. Introduction

Private markets on their own are not sufficient enough to stabilize the economy. They do help in achieving efficiency but at the cost of equity, and for an economy to progress equity and efficiency go hand in hand. This creates an incentive for the government to step in and help in the process of economic development. Central bodies like the government and the Central Banks of a country use several measures to influence the economy and interfere in the market. These are generally classified as Fiscal Policies and Monetary Policies and they are used to influence the demand side of the economy.

The Central Bank generally carries out Monetary Policies and the government focuses on Fiscal Policies but both of them come with their own set of restrictions. Due to this, a combination of the two is generally carried out in the economies.

Fiscal Policy

Fiscal policy is the use of government spending and taxation to influence the economy. Governments typically use fiscal policy to promote strong and sustainable growth and reduce poverty. (Horton.M, El-Gana



iny.A)

Before the Great Depression, economists followed the theories given by classical economists such as Adam Smith, Alfred Marshall, etc., according to which the market should be left on its own and the power of the invisible hand will eventually bring it into equilibrium. But it was when the Great Depression hit and the stock market crashed in 1929 that a need for government intervention arose. Keynes in his paper "The General Theory of Employment, Interest, and Money" called for an increase in government spending. Eventually, World War 2 further cemented the need for a public body and this is how Fiscal Policy came to be.

As previously mentioned Fiscal Policy can be implemented in the following ways:

- 1. Changes in Government Spending i.e. their expenditure
- 2. Changes in the tax rate implemented by the government i.e. their revenue

The Fiscal Policy is further classified into two types:

- 1. Expansionary Fiscal Policies: This is generally carried out by the government to increase the aggregate demand in the economy. This is done either by increasing government spending or reducing the taxes implemented on the people in the society. This is intended to boost the economy by combating the recession, reducing unemployment, increasing consumer demand, etc.
- 2. Contractionary Fiscal Policy: This is carried out to decrease the aggregate demand in the economy, either by reducing government spending or increasing the taxes implemented by the government. This is done to slow down an overheating economy, reduce inflation in periods of high growth, to keep the unemployment level stable, etc.

Overall the objectives of fiscal policies vary from short-term to long-term goals. They are frequently used by the government to influence the economy and it has significant effects on the corporate world and financial markets.

It is essential for anyone who is connected to the corporate world today to understand the implications of fiscal policies on the economy. Both the components of the fiscal policy that is government spending and the imposition of tax affect the world around us in different ways.

Understanding such decisions is crucial for businesses, policymakers, and the general public. Some of the reasons why it is important are as follows:

- 1. Better Planning for the Future: It makes an individual well-informed regarding the decisions of the government and its subsequent impact on the economy which helps them plan better for the future while taking all the risks into consideration.
- 2. Strategic Decision Making: Better knowledge of Fiscal policies allows an individual to make strategic decisions. As changes in fiscal policy affect consumer demand, investment opportunities, etc., so understanding of such situations will help in tackling such situations.
- 3. Impact on Financial Markets: Changes in fiscal policy will inevitably affect the financial market and its factors like stock prices, interest rates, inflation, etc. all of which in turn affect our everyday lives.
- 4. Job Market: They also have a significant impact on the current job market as more spending by the government on say infrastructure like hospitals, roads, etc., leads to job creation in these fields.



- 5. Changes in Aggregate Demand: Whenever the government follows expansionary fiscal policy it leads to an increase in aggregate demand either by supplying more money in the hands of consumers through cuts in taxes or an increase in government spending which itself creates more demand.
- 6. Forecasting Global Trends: Learning about the influence of fiscal policies allows us to forecast global economic trends, which impact businesses, economies, and financial markets all around the world.

Through this research, I focused on the effect of fiscal policies across different countries. Some studies have examined the impact of fiscal policies by taking the example of one country which helps give a thorough analysis of this process. However, my focus for this research will be concentrated on how these policies impact both the developing and emerging economies and to draw a comparative analysis of their response towards such changes.

Ultimately, my objective for this research paper is to analyze the impact of fiscal policies on corporate decision-making and stock market trends, using existing data and literature.

2. Literature Review

A lot of research papers have already been published studying the influence of fiscal policies on corporate decisions and financial markets specific to certain countries.

Pasquale Foresti and Oreste Napolitano (2017) investigated the effects of fiscal policies on stock market indexes in 11 Eurozone members. They found that fiscal policies influence the stock market and that, following an increase (decrease) in the public deficit, stock market indexes go down (up). Nevertheless, further analysis shows that the signs of the estimated stock market reactions are not constant over time and that they change according to the surrounding macroeconomic scenario.

Anghelache Gabriela, Stela Jakova, and Dumitru-Cristian Oanea (2016) analyzed the relationship between fiscal policies and capital markets in 6 European Union (EU) countries from Central and Eastern Europe, from 2004 - 2015. They found a bilateral relationship between fiscal policy and capital market performance for the Czech Republic and Slovakia. In Bulgaria, the fiscal policy affects the capital market return, while in Poland they found that the capital market return affects the fiscal policy.

Craig Doidge and Alexander Dyck (2013) documented interactions between tax incentives and corporate policies using a "quasi-natural experiment" and then imposing a surprise tax on a group of Canadian publicly traded firms. They found that prospective tax shields partially offset the losses, adding 4.6% to firm value on average, and vary with the tax status of the marginal investor. Further, firms adjust leverage, payout, cash holdings, and investment in response to changing tax incentives. Overall, the event study and time series evidence support the view that taxes are important for corporate decision-making.

Djankov, Ganser, McLeish, Ramalho, and Shleifer (2010) presented data on effective corporate income tax rates in 85 countries in 2004. In a cross-section of countries, their estimates of the effective corporate tax rate have a large adverse impact on aggregate investment, FDI, and entrepreneurial activity. Corporate tax rates are correlated with investment in manufacturing but not services, as well as with the size of the informal economy.

Nikiforos T. Laopodis (2010) investigated the effects of military and non-military public expenditures on gross private investment. The empirical evidence from four emerging European countries namely, Greece, Ireland, Portugal, and Spain suggests that in some cases public capital spending stimulates investment, while in others it depresses it. Also, the results tentatively indicate that defense spending exerts no influence on private investment.



David M. Cutler (1988) examined the stock market reaction to the Tax Reform Act of 1986. The Act changes the overall corporate tax burden, the tax rate on corporate income, and the relative treatment of old and new capital. He found evidence confirming the predictions of the Asset Price model according to which after accounting for changes in future cash flows, firms with greater shares of equipment in their capital stock benefit from the tax change. In contrast, firms with greater pre-reform investment rates suffer share declines. However, he found little evidence of a large market response to tax news.

Relevant Theories for this research paper:

2.1. Keynesian Theory:

During the Great Depression in the 1930s, the then-existing theories failed to explain the cause and provide a solution for the worldwide economic collapse. A British Economist at that time, John Maynard Keynes, started a revolution that caused an uproar in the economic world, and for the first time, people's perspective began shifting from the classical economic viewpoint (the free market approach) towards a belief that the government intervention can stabilize the economy.

According to Keynes, the aggregate demand can be represented through the following equation AD = C + I + G + NX

Through the above equation, we can see that company investment decisions are significantly affected by overall consumer demand and business confidence in the economy. These are heavily impacted by government policies, which aim to stabilize aggregate demand in the economy through fiscal and monetary policies. Thus, companies are left to adjust their investment rates in anticipation of the government's future policy plans.

Similarly, for the financial markets, government policies affecting the interest rate or the cost of borrowing money play a crucial role in stabilizing the economy. Other than this, Keynes believed that the key forces driving stock prices are psychology, optimism/pessimism, confidence, and market sentiment. One of his insights is referred to as the "conventional basis of valuation." according to which

The investor is "anticipating what average opinion expects the average opinion to be." In other words, investors base their forecasts of the future price of a stock on what they estimate are the forecasts of other investors, rather than their own judgments of intrinsic value. (Keynes,

Hence, through spending and taxation, the government can intervene to stabilize the economies during periods of recession or excessive growth, thereby affecting the macroeconomy and influencing the corporate sector and financial markets.

2.2. Neoclassical Investment Model

The Neoclassical Investment model developed by Dale W. Jorgenson (1986) focused on the idea of the existence of an optimal amount of capital stock. The firms invest and disinvest only to reach this level of capital. This constitutes the rate of investment.

Investment is further divided into replacement and net investment. Replacement investment is carried out when a firm wants to replace its worn-out capital, whereas net investment refers to the investment that leads to changes in the actual capital stock. They are essential to determine the long-term capital stock. Furthermore, it takes time for a firm to develop new capital so they have to decide at which rate or speed they will be adjusting the existing capital stock in order to reach the optimal/desired level.

For the optimal amount of capital stock, Jorgenson didn't assume it to be fixed instead, it is affected by multiple factors. He defined the optimal stock through the following equation:

 $\mathbf{K}^* = \alpha(p \div r) Y i$



Here,

K*= desired stock of capital

 α = capital share in the production function

(r/p)= real cost of capital

Yi= size of the output

Here as we can see the optimal level of stock depends not only on the output level but also on the ratio of the rental price of capital to the price of output (r/p).

For example, an increase in aggregate demand gives the firm the signal to increase its production in order to sell more products and earn higher profits and this increase in production can only happen when there is an increase in the capital invested by the firm. Similarly, changes in financial costs like interest rates can lead to changes in the optimal capital stock. A decrease or increase in the interest rate has a significant impact on the cost of a project which also affects the investment cost of a firm.

2.3 M&M Theory

The M&M Theorem, or the Modigliani-Miller Theorem, was developed by economists Franco Modigliani and Merton Miller in 1958. According to this, the market value of a company is calculated as the present value of its future earnings and underlying assets and is independent of its capital structure. Here, capital structure is a combination of debt and equity. There are two versions of this theory:

- 1. With the assumption of perfectly efficient markets, the companies do not pay any taxes, and trading of securities is without any transaction cost, there is no bankruptcy cost and information is perfectly symmetrical. Under such assumptions, the capital structure of a form doesn't affect its value, as the value of a company is calculated as the present value of future cash flows
- 2. The 2nd version was developed to better suit the real world. In this version firms do pay taxes, there are transaction and bankruptcy costs and even the information is not symmetrical. Here, the capital structure does affect the company's value by increasing or decreasing corporate information, transaction costs, taxes, and regulations.

2.4 Crowding In Effect

Crowding in refers to the increase in investment in the private sector due to an increase in government spending. Increased government spending leads to growth in the economy which further accelerates investment as they are now more profitable. The increase in investment can be attributed to the income effect of higher government spending.

Crowding in generally occurs when the economy is in recession or below full capacity, then the expansionary fiscal policies carried out by the government increase the economic growth rate and create a positive multiplier effect, which leads to greater private sector investment.

However, Crowding In effect also has its own sets of limitations:

- 1. When the economy will eventually return to its long-run growth rate, interest rates may start to increase deterring private sector investment.
- 2. Recovery can further lead to a rise in inflation, which will further encourage central banks to increase interest rates.

2.5 Crowding Out Effect

Crowding out on the other hand argues that an increase in government spending will lead to a decline or even elimination in the spending by the private sector. The government can only spend more when it has more revenue, and this revenue is generated through either an increase in taxation or through borrowing. These higher taxes reduce an individual's income and increased borrowings can lead to an increase in



interest rate. Hence, such activities of the government lead to crowding out of spending by the private sector.

This reduction in investment by the private sector can offset the benefits brought in by the increased government borrowing. This can lead to a reduction in revenue collected by the government and spur it to borrow more money. Hence, getting caught in a vicious cycle of borrowing and crowding out.

2.6 Efficient Market Hypothesis:

The Efficient Market Hypothesis is an investment theory, according to which all the information in the market is reflected by financial instruments like the share/stock prices.

This theory is based on several key assumptions:

- 1. Stocks are only traded at their fair market price.
- 2. The market price of the stock reflects all the information that is available in the market.
- 3. Investors can't outperform the market since they also have to make decisions based on the same information which is reflected through the stock price.

This theory also comes with several limitations:

- 1. This theory is based on the assumption that the markets are efficient however, there are several markets that are inefficient in nature, i.e., the stock price does not reflect the true value.
- 2. There have been several instances where investors have outperformed the market. Which is in direct opposition to one of the key assumptions of this hypothesis.
- 3. According to behavioral economics, it is irrational for us to assume that all the individuals in the market are rational. Under stressful situations, they might make wrong decisions or make an error while trading in the market.

2.7 Behavioral Finance Theory:

Behavioral Finance Theory is a subfield of Behavioral Economics, that studies the psychological influence on the financial behavior of investors. This field has arrived from the notion that at least a significant minority of investors are affected by behavioral biases, which means their financial decisions at times could be less than rational.

These biases can occur for a variety of reasons and can be classified under five concepts. These are:

- 1. Mental Accounting: It focuses on how people allocate money for different purposes.
- 2. Herd Behavior: Individuals often at times tend to replicate the actions and behavior of the majority of people in a market.
- 3. Emotional Gap: When investors make decisions that are driven by extreme emotions such as anxiety, anger, fear, or excitement. Oftentimes, it's due to these emotions only that people are not able to make a rational decision.
- 4. Anchoring: Individuals at times might attach their spending level to a reference point and this is known as anchoring.
- 5. Self-attribution: When individuals are driven by a tendency to make decisions based on overconfidence in one's own skill and knowledge. Under such a concept individuals might believe that their knowledge is far above others, but the reality could be far different.

2.8. Mundell - Fleming Model:

The Mundell - Fleming model, also known as the IS-LM-BP model, is an extension of the IS-LM model. Where the IS-LM model dealt with an economy under autarky, the Mundell-Fleming model focuses on a small open economy.

It mainly focuses on the idea of an "impossible trinity, " arguing that an economy cannot maintain a fixed



exchange rate, free capital movement, and an independent monetary policy simultaneously. **Some of its basic assumptions are:**

- 1. The domestic rate of interest (r) is equal to the world rate of interest (r^*)
- 2. There is a small open economy with perfect capital mobility.
- 3. It assumes a fixed price level.

The model is based on the following key equations:

1. The IS Curve:

Y = C + I + G + NX

- 2. The LM Curve: M/P = L(i, Y)
- 3. The BoP (Balance of Payments) Curve:
 - BoP = CA + KA

Here,

CA = Current Account Surplus

KA = Capital Account Surplus

NX = Net Exports

3. Research Methodology

3.1. Approach

Secondary research utilizing published data, academic papers, and financial reports.

3.2. Sources

Academic journals, government economic reports, stock market performance indices, and corporate financial statements

4. Analysis and Discussion

4.1. Tax Reforms and Corporate Investment

4.1.1. Introduction

One of the defining factors that affect each and every single firm in the corporate world is the tax policies of the government. It is the major deciding factor that a firm considers before entering the market of the said country. By altering the tax rates, the government significantly impacts the corporate structure, as it further affects the firm investment decisions, capital expenditure, Research and Development spending, etc. The impact of such reforms, however, varies a lot depending on the firm size and industry, and even across developing and developed countries.

4.1.2. Theoretical Framework

Several Economic Theories have laid the groundwork for the relationship between tax reforms and corporate investment decisions. Some of these are:

- 1. According to Keynes's theory, a cut in the tax rate should lead to an increase in the aggregate demand as it leads to an increase in the disposable income of an individual, which further accelerates investment by the corporate sector and vice versa. This increased investment, in turn, leads to higher job creation and growth in the economy.
- 2. A lower tax rate also results in a lower cost of capital for the firm. Hence according to Jorgenson, as the user cost of capital is reduced this should increase the investment rate of the firms incentivizing



them to invest more in capital and other sectors. However, the impact of such tax incentives varies across industries.

3. The M&M Theorem states that in a perfect market where there are no taxes or information asymmetry, a company's value is unaffected by its capital structure. However, when taxes are introduced, the firms can benefit from using debt in their capital structure, as interest payments on debt are tax deductible. Hence, firms with higher debts benefit from tax reductions.

4.1.3. Case Study:

1. The U.S. Tax Cuts and Jobs Act (TCJA) of 2017

The TCJA of 2017 was one of the most dramatic shifts in tax policy in recent US history. The corporate tax rate was directly reduced from 35% to 21% percent starting in 2018. Its major objective was to increase investment and enhance US Competitiveness in the global market.

Impact on Corporate Investment Decisions:

- According to the study conducted by the economist associated with the National Bureau of Economic Research and the Treasury Department, they found that on average, firms that were impacted by the policy change increased their domestic investment by 20% in the subsequent two years of the Act compared to the firms with no tax change.
- TCJA also created incentives for US multinationals to increase foreign capital. This, in turn, leads to incentives to boost domestic investments as well, hence, indicating complementarity between domestic and foreign capital.
- The technology sector benefits from such tax reforms particularly for the intangible assets, leading to high R&D investments.
- On the other hand, TCJA also led to a record \$806 billion in stock buybacks in 2018, which in turn raised concerns regarding the effectiveness of the policy in increasing investment.

2. India's Corporate Tax Cut 2019

In September 2019, the corporate tax rate in India was cut from 30% to 22% for existing firms and from 18% to 15% for new manufacturing units, in an effort to make India's corporate tax rate more competitive with its peers, as historically it has been one of the highest in the world. The other objectives include to induce the firms to invest more and to increase their cash availability, which in turn spurs capital expenditure.

Its implications were:

- For the domestic manufacturing firms, there was a significant increase in the investments. This effect was found to be stronger for larger domestic firms as compared to the small ones.
- According to ICRA, the tax cut that was implemented to make India more competitive doesn't solely affect investment decisions. As due to existing capacity utilization and domestic demand significantly impacted the effectiveness of this reform hence the actual pick-up was a bit delayed.

Overall, the outcome of this tax cut was mixed. On the one hand, it did lead to an increase in investment by domestic manufacturing firms but it also led to huge losses of revenue for the government. Additionally, there were several external factors influencing the market at the moment.

4.1.4. Challenges

While tax policies do have a significant impact on corporate decisions, especially related to capital expenditure they do come with their own set of challenges.

• For both the U.S. and India, the tax cuts were followed by a significant reduction in the revenue earned by the government. In the U.S., the TCJA added approximately \$1 to \$2 trillion to the federal debt as



per the official estimates, and in India, the official estimates of loss in revenue stand at ₹1.28 lakh crore due to the corporate tax reduction.

- Due to such tax policies as seen in the above-mentioned case studies a lot of other countries also respond by adjusting their tax policies which leads to increased global tax competition and sometimes even trade wars.
- Such reductions in tax rates do increase short-term investment rates but long-term gains and effects remain ambiguous. This raises concerns regarding policy effectiveness.

4.2. Government Spending and Corporate Growth

4.2.1. Introduction

Just like how tax policies have a significant impact on corporate decisions, similarly, government spending also plays a crucial role in shaping the corporate world by impaction investment rate, productivity, and market conditions.

Like other fiscal policies, this is also a double-edged sword as on the one hand an increase in government spending on infrastructure, research, public services, etc can create an environment favoring businesses, whereas, on the other hand, it might lead to high interest rates, higher public debt, etc which restricts investment in the corporate sector.

Hence, it is important to understand and analyze the impact of government spending both the benefits and the drawbacks to make well-informed decisions in the corporate world.

4.2.2. Theoretical Framework

The two primary theories interrelating government spending and corporate decisions, particularly regarding investment are Crowding in effect and crowding out effect.

- 1. Crowding In Effect: The crowding in effect is rooted in Keynes's theory according to which increased government expenditure stimulates aggregate demand, giving firms the opportunity to further increase investment. Key areas where government spending impacts the corporate sector are:
- a. Infrastructure Development: Investment in infrastructure projects reduces the cost of production for the firms further increasing their production efficiency and increasing profit margin. These extra funds can be further invested leading to an increase in private-sector investment.
- b. Research & Development: Technological advancements can only happen when there is an increase in spending in the R&D sector. Government funding in such sectors can help the corporate sector in improving its efficiency.
- 2. Crowding Out Effect: Conversely, the crowding out theory focuses on the effect that increased government expenditure might eliminate the investment by the corporate sector. This theory is more rooted in the classical theory, which argues for the minimal role of government. Limitations of government spending on the private sector are due to the following reasons:
- a. Taxation: This increase in government spending can be funded through higher taxation on the private sector, which reduces their disposable income leading to a decrease in consumption and investment.
- b. Borrowings: Higher government expenditure can lead to more borrowings by the government to finance their expenditure which further leads to high interest rates, making it expensive for the private sector to obtain capital for investment

Hence, increased government expenditure has two very offsetting effects. In reality, such impacts are also affected by a number of other factors including the state of the economy, the type of spending, and how is



it being financed.

4.2.3. Case Study:

1. U.S. Infrastructure Investment and Jobs Act (IIJA) – 2021

The Infrastructure Investment and Jobs Act (IIJA), aka Bipartisan Infrastructure Law (BIL), was signed by President Biden on November 15, 2021. This law authorized around \$1.2 trillion for transportation and infrastructure spending including roads, bridges, broadband, and clean energy, with \$550 billion focused toward new investments and programs. Impact on the corporate sector:

- Construction & Transportation: The IIJA has helped fund thousands of new jobs in the construction and highway sectors. The increase in government expenditure has also led to a further increase in demand by the private sector for construction equipment, materials, and workforce expansion.
- Renewable Energy: The IIJA has also emphasized the importance of clean tech energy. This has further stimulated an increase in investment in renewable energy, benefitting firms in the same space.
- Rising Inflation and Interest Rates: This increased government spending has resulted in an increase in inflation. In response, the Federal Reserve also raised the interest rate, which is in turn making borrowing more expensive for the private sector.

2. China's Belt and Road Initiative (BRI) – 2013

China's Belt and Road Initiative (BRI) is a project that was initiated to connect Asia with Africa and Europe via land and maritime networks, intending to increase trade and economic growth. This infrastructure project which is still ongoing has a significant impact on the corporate sector:

- Chinese Companies Beneficiary: The BRI has helped Chinese companies gain international market share and develop into global giants by providing with them contracts to expand their production and increase revenue.
- Trade: By developing such large-scale infrastructure China aims to benefit the export-oriented industries by helping them in reducing their logistical cost. This has reduced transportation time and increased efficiency for these industries.
- Increasing Debt: Many countries involved in the BRI Projects have accumulated high debts. For example, the debt owed by Pakistan to China has increased substantially under this initiative.

4.2.4. Conclusion

Government plays a key role in shaping private sector growth, particularly corporate decision making along with other factors like economic environment, policies, etc.

Through crowding in and out policies, we can clearly see that the effect of such policies can go both ways and it has both a negative as well as positive impact on corporate investment decisions. While strategic policies can help stimulate investment through an increase in aggregate demand, misallocated expenditure can similarly lead to a decrease in investment due to high interest rates and inflationary pressure.

A similar conclusion can be drawn from both case studies as well. On the one hand, such huge investments have resulted in private sector growth but at the same time, there are concerns regarding the high inflation and debt rates.

4.3. Fiscal Policy Announcements and Stock Market Reactions

4.3.1 Introduction

As we have already seen fiscal policies, be it, taxation or government spending, have a significant impact on the economy as a whole, either through inflation, interest rates, or aggregate demand. The effect of these policies can be seen not just in the private sector but also in various financial markets like the equity



market or the stock market. These policies can trigger a significant reaction as investors will form their expectations on the basis of the economic impact of these policies.

For example:

- 1. Increase in Expenditure: This can lead to increased job creation which will further lead to a boost in the disposable income of the individuals. This will lead to an increase in consumer demand, increasing the profits of the company, and eventually an increase in the stock price.
- 2. Reduction in Taxation: A similar effect is followed by a decrease in the taxation policy. This will again increase the disposable income of individuals and companies further accelerating demand and hence leading to a higher stock price in the market.

4.3.2. Theoretical Framework:

Various theories have been founded by economists to study and explain the impact of fiscal policies on the stock market. These include:

- 1. Efficient Market Hypothesis: According to this hypothesis, as efficient markets reflect all the information through the stock prices, then a change in fiscal policy should also be reflected through an adjustment in the stock price, based on the expectations of the investors. However, if the market is not fully efficient then there could be some misjudgment on the investor's part.
- 2. Keynesian Fiscal Theory: As stated earlier, an expansionary fiscal policy leads to an increase in aggregate demand in the economy, which in turn positively affects the stock prices and vice versa.
- 3. Behavioral Finance Theory: The psychology of an investor has a significant impact on the decisionmaking of an investor regarding the fluctuations in the stock market due to changes in fiscal policy. Their overreaction to certain news or their expectation regarding the future impact of such policies dictate their action in the stock market, which when aggregated for a large group of investors has a significant impact on the stock market and the prices prevailing in it.

4.3.3. Long-Term Vs Short-Term Impact and Bearish Vs Bullish Markets:

1. Short Term Impact vs Long Term Impacts

The impact of fiscal policies on the stock market can further be segregated into long-term and short-term impacts, due to the deferring reaction of investors to such policies.

a. Short Term Impact:

The market's short-term reaction often reflects the immediate impact of such policies. Be it the investor's sentiment or the expectation of these policies in the long run. Expansionary fiscal policies are often well received in the short term, leading to a boost in stock prices due to high growth in the economy.

b. Long Term Impact:

The Long Term reaction of the market depends upon the actual outcomes of the policies and the market response to the same. Long-term expansionary fiscal policies can also lead to high inflationary pressure leading to a decline in the stock market.

2. Bearish Markets vs Bullish Markets:

In the Investment market, the terms 'Bull' and 'Bear' are generally referred to market conditions. It is used to describe whether the stock markets are appreciating or depreciating.

a. Bullish Market:

A bullish market is one that is on the rise and economic conditions look favorable for the market. In such markets, the price is expected to rise and even the investors are optimistic that this will continue for a long period. A market is considered a "bull" when there has been a 20% recovery from the market bottom. In such a situation the employment levels are high and the economy is considered to be quite strong.



b. Bearish Markets:

In contrast, a bearish market is the one that is on a decline. They exist when the economy is generally receding and the stock market prices are actually falling. Generally, a market is considered to be a true "bear" only when there has been a price decline of 20% or more from its peak. The downward is believed by the investors to continue. Hence, it leads to a rise in unemployment and a slowdown in economic growth.

Hence, the impact on the stock market is a culmination of multiple effects including the direct impact of fiscal policies and the indirect impact due to the duration of policy, the market condition, and the reaction of the investors to such policies.

4.3.4. Case Study:

The U.S. CARES Act (March 2020) and Stock Market Reaction:

The CARES Act (The Coronavirus Aid, Relief, and Economic Security Act (2020)) was implemented on March 27, 2020, in response to a slowdown in the economy due to the Covid 19 Pandemic. It provided over \$2 trillion of economic relief to workers, families, small businesses, industry sectors, and other levels of government that have been hit hard by the public health crisis.

Impact on the Stock Market:

- Ever since COVID-19 was announced as a pandemic the stock market, especially the S&P 500 index experienced significant volatility. However, since the CARE Act was announced and signed by President Trump there has been a notable rebound in the stock market. In the week that the bill was passed, the market capitalization value of the S&P 500 rose by \$2.6 trillion, or 13.3 percent, between March 23 and March 27.
- The impact across industries and sectors was quite different. Information technology and • communication services sectors outperformed due to an increase in demand during a pandemic and their adaptability to changes in consumer behavior. On the other hand sectors such as the retail and the leisure and hospitality sectors were hit the hardest.
- The rapid rebound of the stock market just after the CARE Act was implemented shows that the • investors have expected a positive effect on the economy due to the fiscal stimulus under the Act. It shifted the sentiment in the market making investors more optimistic regarding the near future.

Through the CARES Act implementation, we can see the role of fiscal policy in affecting financial markets like the stock market. Not only did it directly affect the fiscal stimulus but it also had an indirect impact by changing the psychology and the beliefs of the investors regarding the future of the stock market.

4.3.5. Conclusion

The impact of fiscal policy announcements and its subsequent impact on the stock market can be seen as a very complex relationship. From short-term impacts to long-term impacts and then from bearish to bullish market conditions along with the changes in tax and expenditure policies significantly alter the expectation of the investors attached to the policy in the short run further leading to large long-run impacts. As seen from the CARE Act case study in the US market during the COVID-19 pandemic the impact varied across both time and sectors, driven by the aggregate demand and investor decisions in the commodity market and stock market respectively.

Such policies are a powerful tool not only to stabilize the economy and its subsequent markets but also to dictate the growth of the economy in the long run.



4.4. Interaction of Fiscal Policies with Global Factors

As we already saw fiscal policies impact different economies domestically and how even certain domestic factors have an effect on fiscal policies. But since we live in a globalized world that is very much interconnected several other factors related to the international economy also play a key role in interacting with fiscal policies. These include factors like interest rates, trade policies, etc.

4.4.1. Interest Rates and Capital Flows

Due, to changes in the fiscal policy, either through taxation or government expenditure, factors such as interest rates are affected. According, to the Mundell-Fleming model when interest rates shift it leads to an upward shift in the BoP curve which causes capital flows out of the economy. This in turn depreciates local currency and boosts exports, thus shifting the IS curve to the right.

For example: an expansionary fiscal policy, that is, a reduction in tax rates or an increase in government spending leads to an increase in domestic interest rates. This increase attracts foreign capital, as investors seek higher returns, resulting in an appreciation of the domestic currency. This leads to a situation where imports are cheaper, hence, decreasing net exports and putting off the initial fiscal stimulus.

4.4.2. Trade Policies and External Demand

Over the years the relationship between the fiscal policies and trade balance have been closely observed by the economist.

- 1. A fiscal policy expansion generally leads to an increase in demand in the domestic market. This demand transverses borders and often leads to an increase in imports as well. Which further decreases our net exports thus widening our trade deficit and putting off the initial fiscal expansion.
- 2. Conversely, such expansions can also have positive spillover effect on other countries stimulating expansion of economic activities. As when the domestic country starts importing it leads to an increase in production, employment opportunities etc, in the exporting country. Even the global financial markets get a boost as investors seek for higher profits leading to higher stock prices and lower borrowing costs.

5. Findings

5.1. Key Insights

5.1.1. Correlation between Fiscal Policy Changes and Corporate Investment Patterns

Through our analysis, it is clearly evident there is a significant relationship between changes in fiscal policy such as tax changes, government spending, and the subsequent changes in corporate decisions particularly investment.

The private sector in both developed and developing countries responds to fiscal changes, but the magnitude of the change depends upon other factors like the macroeconomic environment and the market conditions.

5.1.2. Stock Market Volatility Linked to Fiscal Policy Announcements

The impact of the announcements particularly related to the fiscal policies has both short-term and long-term impacts on the stock market.

This volatility also depends upon a number of other factors like the investor's expectation of the market changes, the long-term impact, and the initial uncertainty regarding the policy.



5.2. Patterns:

5.2.1. Developed vs. Emerging Economies: Differential Impact of Fiscal Policy

- 1. Developed Markets: They generally have high fiscal policy stability and well-established financial institutions that help corporates and investors to make well-informed decisions. Most of the impact is judged to be long-term rather than short-term.
- 2. Emerging Markets: They are more prone to higher volatility due to fiscal policy, weaker financial institutions, and even greater vulnerabilities. Hence polices have both short and long-term impacts on corporate decisions and the stock market.

6. Implications

6.1. For Policymakers:

Through this analysis, we can see that it's important for policymakers to focus not only just the direct impact of fiscal policies on the market but also on the indirect impacts through the corporate sector and financial markets. They should focus on the following points:

- 1. Tax Reforms: It is necessary for policymakers to structure tax policies in a way that not only directly boosts economic activities but also incentivizes high corporate investment levels and less volatility in the stock market through transparent and easy-to-understand policy.
- 2. Government Expenditure: Well-defined and transparent policies related to government spending will lead to an overall increase in the demand in the economy. Thus stimulating production and economic growth.

6.2. For Investors:

Understanding how fiscal policy changes impact financial markets can help investors make more informed decisions.

- They should be aware of the sectoral differences in reacting to these policies.
- They should form expectations based on previous empirical evidence and adjust their portfolios accordingly allowing them to hedge against uncertainty.
- It is also important to take into account the varying impact of such policies on different economies like developed vs emerging.

6.3. For Corporates:

The private sector should be quick in adapting to the changing circumstances due to the new fiscal policies.

- Long-term investment decisions should incorporate fiscal policy changes, particularly in sectors that heavily rely on government policies.
- It is important for the corporate sector to analyse the impact of changes in tax policy on the cost and revenue structure of the firm to plan long-term projects.

It is important for policymakers to take into account the long-term policy impact of their policies in order to help in the growth of the economy. Simultaneously it is important for investors and private sector to understand these policies and their impact in order to navigate their future path.

7. Limitations

- Dependence on secondary data may limit the granularity of insights.
- Potential biases in data interpretation or incompleteness of available literature.
- While the research does identify the correlation between fiscal policy the corporate sector and the stock market, it is not possible to establish causality.



- Other factors like monetary policies or global economic conditions might have a significant impact on corporate investment decisions and the stock market other than fiscal policy.
- It is difficult to separate just the impact of fiscal policy as real-world economies are constantly affected by geopolitical events, trade policies, and other factors.

8. Conclusion

This paper highlights the relationship between fiscal policy, corporate investment strategies, and stock market behavior.

Key findings suggest that changes in fiscal policy have a significant impact on corporate decision-making. Similar effects could be seen in the stock market volatility after fiscal policy announcements. The crosscountry analysis helped in seeing the varying effects of such policies on developed and developing countries.

These findings suggest having a well-defined, structured, and transparent policy, which will, in turn, boost investor's confidence and reduce market fluctuations. Such policies will even help the corporate sector to make well-informed decisions particularly relating to investment after integrating the change in fiscal policy.

Future Research Areas:

It is a very broad topic and further research in this area and analysis is important to enhance our understanding in this field. This could be done in the following areas:

- 1. Sectoral Analysis: Fiscal policies impact different sectors differently. Hence, a more in-depth study in various sectors is essential to understand the true essence and impact of such policies.
- 2. Impact of AI: With the advent of AI in today's world it is important for us to understand the implications this new emerging technology can have on policy making and its subsequent impact on the corporate sector and financial markets.
- 3. Behavioral Economics and Finance: Fields like behavioral economics and finance only started emerging recently in the 1990s. Hence it's important for us to understand the impact of such fields that is the psychology of the investors and people in the private sector in response to changes in fiscal policy.

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