Fiscal policy and the growth slowdown

Several economists have recently argued for increasing public expenditure, through deficit financing, to address the current growth slowdown. This argument rests on the premise that increased government spending would enhance purchasing power in the hands of consumers and firms and, thereby, increase aggregate demand to bolster growth.

I want to unpack the analytics of this argument. For those who consider the current slowdown to be "cyclical" (I don't), this is an obvious textbook prescription — spend more during downturns, less during upturns.

This argument is misplaced. First, public spending has, in fact, been expansionary over the past few years. While on-budget fiscal expansion at the Centre is limited by the perceived need to keep the reported fiscal deficit/GDP ratio under control, off-budget borrowings have easily crossed 1 per cent of GDP, even by my conservative estimates that are much lower than those reported by the Comptroller and Auditor General of India. Second, some commentators repeatedly, and wrongly, assert that the 3 per cent fiscal deficit target is arbitrary; they seem ignorant of the reasoning embedded in every report of the Finance Commission and fiscal responsibility and budget management since 2003, that with financial savings at around 10 per cent of GDP, the public sector borrowing requirement is no less than 7.5 per cent of GDP, even discounting off-budget borrowings. Further increases in public sector debt would only add to the high cost of capital that is sought to be lowered on the monetary and credit policy side. Gains on the fiscal swings mean losses on the monetary roundabouts. Glib allusions to "counter-cyclical" policies without considering these realities is irresponsible.

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Fiscal expansion on purportedly Keynesian grounds can be secured through the balanced budget multiplier. When growth is demand constrained, government taxes private income and increases its own consumption or investment expenditure to boost aggregate demand. Thus, increased taxes finance increased public spending, with a net positive impact on aggregate demand. This does not work if taxes are not elastic or if the fiscal machinery is demonstrably unable to increase the tax-to- GDP ratio at will. So, the implicit assumption (justified in the Indian context) is that this is not possible; the second best solution must be adopted — government must borrow more. I wish new-born Keynesians would make this explicit.

The question then is: On what should government spend this extra borrowing? India has long been in a situation where over two-thirds of central government borrowing is for revenue expenditure. Borrowing for public investment sounds like a good idea but the fact is that a lot of public investment (like defence), involves spending on imports; a further chunk has been deployed for financial investment, not fixed capital formation. Fixed capital formation at the central level is too small, and the time lags in executing such investment too long to make a difference, even if the magnitude is temporarily doubled.

Government can borrow to increase revenue expenditure on transfers. This would alleviate the problem as long as the macroeconomic assumption is that there is capacity underutilisation across the economy. But I have been pointing out for some time now that the Indian economy faces a structural demand problem driven, *inter alia*, by the lack of wider participation in economic activity, limiting effective aggregate demand, even as growth slows in extant sources of demand for things measured by the "leading indicators" (automobiles, FMCG, consumer durables) of the economy. Add to this the problems faced by the financial sector, poor transmission of credit policy, and a public sector and public administration that is, collectively, a deadweight drag on productivity (with a few honourable exceptions) due to years of neglect of necessary administrative and structural reforms.

In these circumstances, transfers will, at best, facilitate a temporary increase in aggregate demand in sectors other than the leading indicators. The supply response to this will persist only if such transfers financed by borrowing are maintained over the medium term. This is because the aggregate demand increase is powered only by transfers, not increases in income. Since the problem is structural, it will not go away, simply by boosting generic aggregate demand through transfers. Hence, permanently increasing government borrowing to pay for transfers would only reinforce the structural demand problem.

And should I even bother pointing out the negative consequences of such persistent fiscal imprudence, and the historic price India has had to pay for this, across our history? The addiction to deficit financing seems to afflict so many policy commentators, with the result that (as former CEA Shankar Acharya wrote in, "Fiscal deficits — a short history", March 8, 2017, *Business Standard*) the historic record of central government on deficit financing resembles that of an alcoholic struggling to keep addiction at bay.

Of course, an asset rich, but revenue poor, central government could monetise and deploy assets to boost aggregate demand by pursuing laudable structural policies like doubling farmers' income and scaled up investments in renewable energy and affordable housing. This government has shown willingness and fiscal appetite for such initiatives, but not, yet, the political will to address the binding constraint —the regulatory and institutional legacy hurdles that inhibit the speedy execution of these initiatives. Event management can distract from, but not permanently mask, execution failures. Addressing these hurdles that do not cost money should be the central focus of economic policies when faced with a structural slowdown that has deep domestic roots.

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