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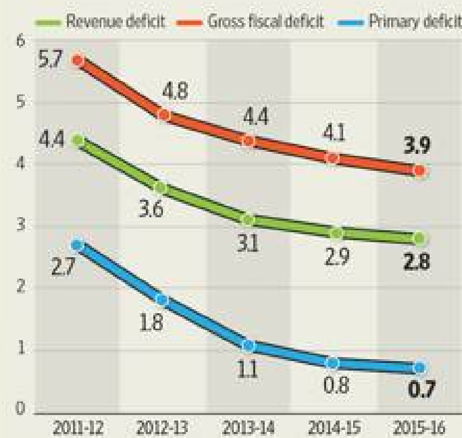

OBFUSCATING JARGON

BEWARE OF DEFICIT FETISHISM

EXPERT VIEW

DEEPAK NAYYAR
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Arun Jaitley will present the Union budget in Parliament on the last day of this month in what is a leap year. It will be four years before 29 February comes around the next time. The forthcoming budget is also a window of opportunity for the finance minister that might not be available again during the remaining term of this government.

In the realm of politics, for citizens, their patience awaiting *achche din* is on the wane while their goodwill is beginning to erode. It is time for the government to act. Fortunately, the compulsions of electoral politics are at an unusual low in a republic where election season never seems to end. The state elections due this year—Assam, Kerala, Tamil Nadu and West Bengal—are of little significance to the Bharatiya Janata Party (BJP). But the elections due in 2017—Punjab and Uttar Pradesh—will be critical. Although this government has been in office just over 18 months, this is the third budget to be presented by Jaitley with just two more to follow because only an interim budget can be presented in February 2019.

In the sphere of economics, there is some bad news. Expenditure is bound to jump with the much higher salaries for government employees following recommendations of the Pay Commission and the implementation of one-rank-one-pension for the Armed Forces. But there is also good news. The collapse of world crude oil prices, with little prospect of reversal during the next financial year, will reduce expenditure on subsidies and increase revenue from taxes on petrol and diesel. The benefits from the latter are greater than the costs of the former. This means more space and greater flexibility in the budget to come.

There are two conflicting views, even among those who seek to counsel the government. At one end, there are those who want a reduction in the fiscal deficit in conformity with the targets. They believe in the virtues of fiscal consolidation. At the other, there are those who want fiscal expansion to boost the economy through domestic demand in the face of a global slowdown. They hope that stepping up public investment would kick-start private investment to revive economic activity. It is posed as a dilemma but the choice is obvious. If the object is to drive economic growth and foster employment creation, the budget must loosen the purse strings.

This decision would be much easier for the government to make and for the people to understand, in terms of common sense, if we get away from the obfuscating jargon and false precision of economists. It is possible to simplify the artificial complexity.

Much of the discussion refers to the fiscal deficit of the government. This generic term conceals more than it reveals. There are different concepts of deficits in government finances, often used in an interchangeable manner, which is misleading.

The gross fiscal deficit measures the difference between revenue receipts plus grants and total expenditure plus net domestic lending, where the latter exceeds the former. In simpler words, it is the difference between total income and total expenditure of the government, which is financed by borrowing. Therefore, it also provides a measure of the increase in public debt during the year.

The revenue deficit, or surplus, measures the difference between the revenue receipts (made up of tax revenues plus non-tax revenues) and consumption (non-investment) expenditure of the government, to focus on transactions that affect the income or expenditure of the government (and not its net wealth or debt position). Hence, it provides a measure of government borrowing that is used to support consumption. But this measure can overstate the problem because interest payments on outstanding government debt are revenue expenditure.

The primary deficit is the gross fiscal deficit minus interest payments. This matters because, where government debt is high as a proportion of GDP, interest payments constitute a large, pre-emptive, component of government expenditure, and public debt that has been accumulated over time means that a large gross fiscal deficit will persist for some time even after correctives have been introduced. Thus, the primary deficit shows more clearly whether the fiscal situation is getting better or worse.

Macroeconomic policy debates often hinge on variables such as deficits in government finances, based on accounting frameworks, which can be inappropriate or misleading. The reason is simple. Such measures are like a thermometer. If it shows that the body temperature is above normal, it signals that something is wrong. But a thermometer does not provide a diagnosis for a patient. Similarly, an accounting framework can never provide a diagnosis, let alone a prescription, for an economy.

The accounting frameworks in use for government deficits are an almost perfect illustration of this problem. What matters is their macroeconomic significance. If the objective is to measure the total borrowing needs of the government, and what it means for the sustainability of government debt, the gross fiscal deficit is the most appropriate. If the objective is to assess whether a fiscal regime is sustainable over time, the revenue deficit is the most appropriate, although it would need to be adjusted for interest payments. If the object is to examine what the government has done, or can do, to improve the fiscal situation, the primary deficit is the most appropriate.

The figure shows a clear downward trend in each of the three deficits over the past five years. The revenue deficit remains higher than it should be (partly because interest payments are very large), but the drop in the primary deficit, to less than 1% of GDP, is worth noting.

In this context, the obsessive concern of the discourse in the government, mirrored in the media, with the gross fiscal deficit of the central government (as if gross fiscal deficits of state governments are irrelevant) is, to say the least, baffling.

The orthodox belief is that reducing the gross fiscal deficit is clearly necessary and almost sufficient for a sound macro-management of the economy. This is a myth. The size of the fiscal deficit, or the amount of government borrowing, is the symptom and not the disease. And there is nothing in macroeconomics that stipulates an optimum level to which the gross fiscal deficit must be reduced as a proportion of GDP. It is possible that a fiscal deficit at 6% of GDP is sustainable in one situation while a fiscal deficit of 3% of GDP is not sustainable in another situation. The real issue is the allocation and end-use of government expenditure in relation to the cost of borrowing by the government. Thus, government borrowing is always sustainable if it is used to finance investment and if the rate of return on such investment is greater than the interest rate payable.

In an ideal world, there should be a revenue surplus large enough to finance capital expenditure in the social sectors, as also on defence, where there are no tangible returns. This would ensure that borrowing is used only to finance investment, which yields a future income inflow to the exchequer. If government borrowing is used, in part, to support consumption expenditure, the rate of return on investment financed by the remainder of the borrowing must be high enough to meet the burden of servicing the entire debt.

Even so, orthodox economics is strongly influenced by a simple analogy between governments and households, which propagates the belief that, just as it is not possible for households to live beyond their means, for it can only end in financial ruin, it is not possible for governments to live beyond their means, for deficits and debts can both become unsustainable. The moral of the story is balanced budgets, essentially through a downsizing of government. Such conventional thinking forgets that there is a fundamental distinction between good management of household finances by an individual and sensible management of the economy as a whole by the government. This distinction cannot and should not be blurred.

It is not possible for a household to live beyond its means because borrowing to meet consumption expenditure is unsustainable. But it may sometimes be necessary for the government to borrow for financing non-investment expenditure, within limits, particularly if it stimulates investment or increases output in the private sector, thereby leading to an increase in the income of the government. The essential point is that what is efficient for a household at a micro-level is not necessarily efficient for the government at a macro-level because the whole is different from the sum total of the parts.

In any situation of macroeconomic imbalances, governments can adjust by either reducing expenditure or increasing income. Economists who insist on fiscal discipline urge the government to accept the pain of adjustment, rather than focus on promoting economic growth and fostering employment creation, even if it means a lower output today in the hope of a higher output tomorrow. This recommendation conforms to the strong spring analogy: the harder you push the spring down, the greater the force with which it bounces back. But a weak spring is a more appropriate analogy for the economy, for when it is pushed too hard it may simply remain there if its restorative forces are destroyed. Such a prescription must carry a statutory warning: the solution might turn out to be worse than the problem!

Unlike economists, however, politicians are accountable. In our vibrant democracy, people assess performance of the government in terms of development outcomes that affect their lives. What matters most is employment possibilities and income levels.

In a situation where there is a slump in investment, stagnation in agriculture, and contraction in manufacturing at home, juxtaposed with a global slowdown, growth in output and employment will depend upon a revival of domestic investment and consumption. The sharp drop in inflation, attributable largely to the collapse in world crude oil prices, makes it possible. It needs fiscal expansion rather than fiscal retrenchment. The Union budget should be counter-cyclical, stepping up public investment in infrastructure and increasing capital expenditure in social sectors. In doing so, the finance minister must reject deficit fetishism.

Deepak Nayyar is emeritus professor of economics, Jawaharlal Nehru University, New Delhi. He served as chief economic adviser to the government of India, from 1989 to 1991, and as vice chancellor, University of Delhi, from 2000 to 2005.