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Wrong time for fiscal squeeze

Given the slowdown and downturn in the economy, counter-cyclical fiscal policies are essential to revive economic growth and foster employment creation

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The Union budget for financial year (FY) 2018-19 will be presented in Parliament on 1 February. It will be the fifth time for Arun Jaitley as Union finance minister. It might also be the last budget of this government. Of course, a sixth budget is possible, as the date of presentation has been brought forward from 28 February to 1 February, so that it can be approved by Parliament before the end of the financial year. But it might not be desirable with a general election due soon thereafter. It would be more appropriate to present an interim budget in February 2019 so that the regular Union budget for FY20 is presented by the new government that assumes office. In either case, the budget to come next month is critical, not only in the sphere of economics but also in the realm of politics.

In the polity, the government is on the last lap of its tenure. But the compulsions of electoral politics are far greater in a democracy where the election season never seems to end. There are elections due in eight states this year: Meghalaya, Nagaland and Tripura in February, Karnataka in April, followed by Mizoram, Chhattisgarh, Madhya Pradesh and Rajasthan in December. The Bharatiya Janata Party (BJP) would like to retain power in Chhattisgarh, Madhya Pradesh and Rajasthan. And it would like to capture Karnataka. In the small north-eastern states, the BJP aspires for a political presence. Thus, elections in these states will matter. Moreover, general elections are due in April-May 2019, which might be brought forward to coincide with state elections in December 2018. The performance of the economy will be a critical determinant of electoral outcomes.

In the economy, the conjuncture is problematic. There is a distinct slowdown in economic growth. Employment creation, already too little, has slowed down even more. The persistent recession and fragile recovery in the world economy, juxtaposed with a political backlash against globalization in industrialized countries, means that external markets cannot provide the demand to stimulate growth. The good news is that inflation is moderate and world oil prices are still low. Yet, the economy remains vulnerable to shocks such as a jump in oil prices or a bad monsoon.

The fiscal situation has slipped. It is reported that the gross fiscal deficit of the Central government exceeded the target for the financial year, in end-November 2017, with four months to go. Thus, for FY18, revised estimates are likely to diverge significantly from budget estimates. There are revenue shortfalls attributable to the complex structure and hasty implementation of the goods and services tax (GST). There are expenditure overruns. Some are for real, while others are attributable to intended underestimates in the budget. It is possible that the forthcoming budget resorts to an adjustment of revised estimates—revenue and expenditure—so that the fiscal deficit conforms as closely as possible to what was targeted. This might pass muster because actual accounts are available only six months later.

Creative arithmetic apart, Jaitley has three choices. He could hope that revenues might rise in the last quarter despite the expected drop in gross domestic product (GDP) growth. That would be unwarranted optimism. He might implement expenditure cuts in the last quarter. That would be counterproductive and might dampen growth further. He could allow the fiscal deficit to exceed the target. That would be the best solution, even if orthodoxy complains. The choice is important not so much for FY18, which is coming to a close, but because it will shape the budget for FY19.

There are two polar opposite views about what should be done. At one end, there are those who want a reduction in the fiscal deficit in conformity with the targets: 3.2% of GDP in FY18 and 3% of GDP in FY19. They have an ideological belief in the virtues of fiscal consolidation. At the other end, there are those who want fiscal expansion to boost growth in the economy through domestic demand in the face of a global slowdown. They hope that government expenditure on consumption and investment will stimulate demand to revive economic activity. This choice is posed as a dilemma. For me, if the object is to drive economic growth and foster employment creation, the choice is obvious. In an economic downturn, fiscal policy must be expansionary. The budget should loosen the purse strings. Jaitley must opt for courage to do better rather than for caution to do more of the same.

There has been a slowdown in economic growth for seven successive quarters, from January 2016 to September 2017, as GDP growth has been lower than that in the corresponding quarter of the previous year. There is a popular perception that this might be attributable to demonetization in November 2016 and the introduction of GST in July 2017. But this belief is not tenable since it can at best explain decelerating growth in the last three quarters. In fact, the economic slowdown has been with us for seven years rather than seven quarters. Average annual GDP growth, which was around 9% during 2003-04—2010-11 (excluding 2008-09) dropped to 5.4% during 2011-12—2013-14, revived to 7.5% during 2014-15—2016-17 but is expected to be lower at 6.5% in 2017-18.

It would seem that there are structural constraints on growth that have persisted. In terms of macroeconomics, the underlying factors—sluggish investment and sluggish exports—have remained unchanged for seven years. Investment (gross fixed capital formation) as a proportion of GDP dropped from 31.8% in 2011-12 to 28.3% in 2013-14 and from 30.4% in 2014-15 to 27.1% in 2016-17 and an estimated 26.4% in 2017-18. Merchandise exports as a proportion of GDP were in the range of 16-17% during 2011-12—2013-14 but dropped from 15.2% in 2014-15 to 12.2% in 2016-17 and will be less than 12% in 2017-18.

Why are investment and exports important determinants of economic growth? The three sources of growth on the demand side are consumption, investment and exports. However, consumption, whether in the private sector or the government sector, depends on their respective income levels, which in turn depend upon growth. Thus, investment, which is decided upon within the economy, and exports, which depend on world demand for our goods, are the primary, autonomous sources of demand that drive growth in output. Investment and exports are also critical determinants of growth from the supply side. Investment creates capacities or raises productivity, both of which increase output from the supply side. Exports, which must be price- and quality-competitive in world markets, raise efficiency and productivity of exporting firms to drive growth in output.

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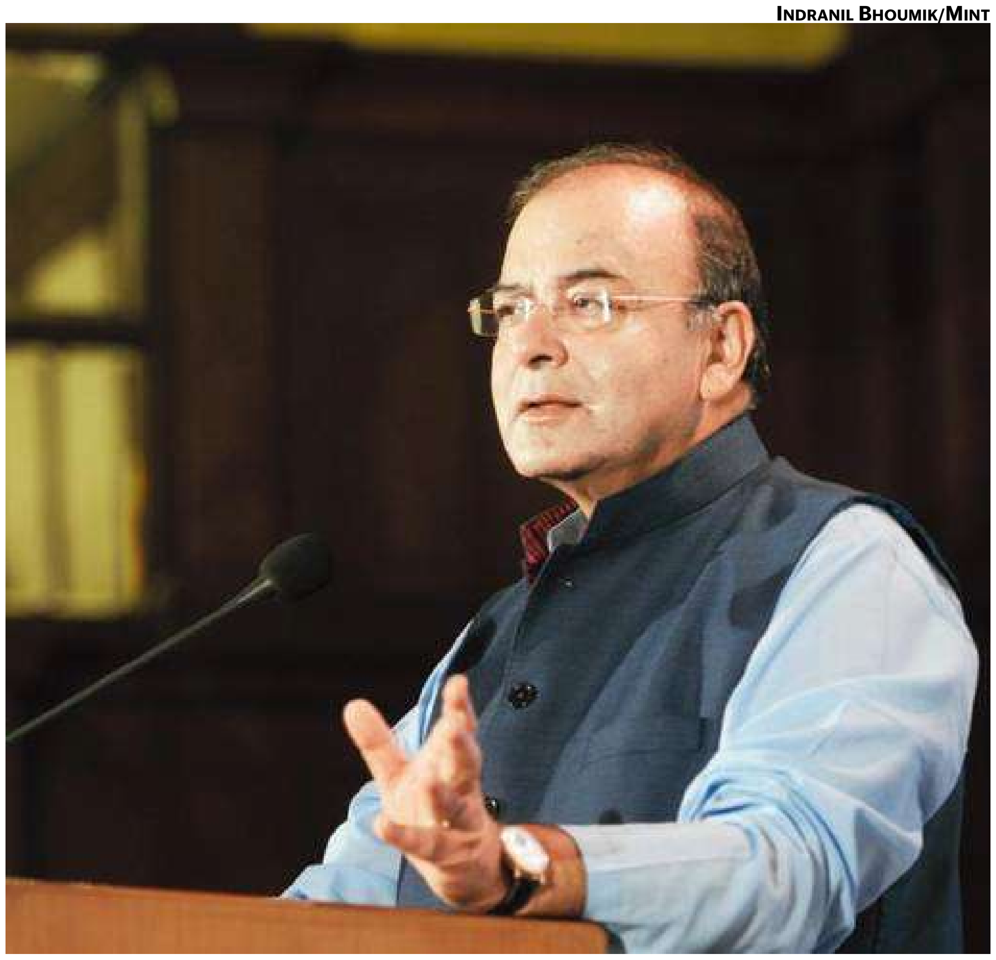

The obsessive concern of the Union ministry of finance with the gross fiscal deficit of the Central government is baffling

Monetary policy should provide stimulus to private investment by lowering interest rates. The Reserve Bank of India stubbornly resists, caught in the flawed belief system that inflation can be controlled by high interest rates, refusing to recognize that it was the low oil prices rather than high interest rates that tamed inflation. The exchange rate of the rupee has continued to appreciate in real terms (adjusted for inflation) for three years, partly because of the macho pride in a strong rupee but largely because of a desire to maintain profitability of portfolio investment inflows which finance current account deficits. It has really hurt export performance. The only option, then, is for the budget to stimulate investment, as also consumption, to revive economic growth.

This can happen if, and only if, the government gives up its deficit fetishism. There is nothing in macroeconomics that stipulates an optimum level to which the fiscal deficit of the government must be reduced as a percentage of GDP. 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. Hence, there is nothing sacrosanct about keeping the fiscal deficit at 3% of GDP. The obsessive concern of the Union ministry of finance, mirrored in the media, with the gross fiscal deficit of the Central government—as if fiscal deficits of state governments are irrelevant—is even more baffling.

Sensible economics should, in fact, focus on the revenue deficit—difference between revenue receipts (tax plus non-tax revenues) and consumption (non-investment expenditure of the government)—which measures government borrowing used to support consumption. The effective revenue deficit, which is the revenue deficit minus grants for the creation of capital assets, is an even better measure. In 2017-18, these are estimated at 1.9% and 0.7% of GDP, respectively. The primary deficit, which is the gross fiscal deficit minus interest payments, reflects whether the fiscal situation is getting better or worse, is estimated at a negligible 0.1% of GDP in 2017-18. These numbers suggest that the fiscal situation is not a cause for concern. Indeed, the gross fiscal deficit could be allowed to stretch to 3.5-3.75% of GDP, without even affecting the revenue deficit, if all the extra borrowing is used to finance investment.

Given the slowdown and downturn in the economy, counter-cyclical fiscal policies are essential to revive economic growth and foster employment creation. Expenditure cuts are the exact opposite of what is needed. Instead, it is necessary to increase public investment, especially in infrastructure, just as it is necessary to increase public expenditure, particularly in education and health, which is in effect an investment in people that would improve their well-being and raise their productivity. Government deficits are better managed by increasing revenues for which there is ample scope just by improving tax compliance. Our direct tax rates are among the lowest in world. So are direct tax-GDP ratios. It is time to remove exemptions and deductions. GST is a step in the right direction for indirect taxes. But it is essential to reduce its multiplicity of rates and complexity in administration.

The irony of the situation is striking. The political compulsions of the government and the economic priorities of the people require much the same things from the Union budget. Yet, fiscal conservatism and economy orthodoxy might prevent this, even in a year with so many elections on the horizon.

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