Article

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Fiscal Deficit and Crowding Out: Case for an Expansionary Fiscal Policy

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Abstract

In an editorial on April 3, 2020, the Financial Times, a neoliberal mouthpiece wrote: "Radical reforms in reversing the prevailing policy direction of the last four decades will need to be put on the table. Governments will have to accept a more active role in the economy. They must see public services as investment rather than as liabilities and look for ways to make the labour market less insecure. Redistribution will again be on the agenda… Policies until recently considered eccentric such as basic income and wealth taxes will have to be in the mix." This emphasizes the role of fiscal policy and redistribution to boost economic recovery in a worldwide recession. In this paper we discuss in detail the role of globalized finance in determining fiscal policy in sovereign states. At the same time, we also explore the phenomena of crowding out in demand constrained economies in general and Indian economy in particular.

Keywords: Fiscal Deficit, humbug of finance, government, autonomous spending, expenditure, underdeveloped, crowding out, inflationary pressures.

Fiscal Deficit: Definition and Political Economy Rationale

The 1920s were a period when finance capital dominated, and finance ministers of all the capitalist countries rigidly adhered to the dogma of balanced budgets and deflationary solutions to solve balance-of-payments problems (Patnaik, 2003). Joan Robinson had referred to this view of a balanced government budget as the 'humbug of finance' (Robinson, 1962) propounded by finance capital with no underlying theoretical merit. In the present times, the fiscal deficit is restricted to a 3 percent 'permissible' target, constituting the 'humbug of finance' (3 percent as opposed to a balanced budget). Most of the obsession among fiscal conservatives revolves around this figure.

In a dirigiste regime, government spending acts as an 'automatic stabilizer' during an economic downturn. However, in neoliberalism, the threat of international capital flight (that can cause a hurtful financial crisis) prevents democratic government from taxing capital or enlarging deficits through autonomous spending. In the Indian context, it has resulted in the tightening of central government funds to the states to uphold its 'fiscal responsibility'. This directly affects welfare expenditure in the underdeveloped states.

Fiscal Deficit is the difference between the total income of the government (total taxes and non-debt capital receipts) and its total expenditure. A fiscal deficit situation occurs when the government's expenditure exceeds its income. A common misconception floated is that instead of borrowing for its expenditure, if the government undertakes the sale of public sector assets or even government land, then the government can show a smaller fiscal deficit figure, adhering to fiscal responsibility. The proceeds from the sale of the assets are in fact shown as government income (on par with tax revenue).

Now, there is a fallacy with assuming sale of public sector assets as government income. A fiscal deficit does not cause crowding out or inflationary pressures in a demand constrained economy due to simultaneous output and price adjustments. This is because the 'fixed pool of savings' increases as output increases and there are no borrowing constraints on the private sector borrowing. However, even if we assume that a 'fixed pool of savings' exists, sale of public sector assets will not solve the problem of borrowing shortfall for the private sector. Similarly, if fiscal deficit causes inflation with excess demand, privatisation will not reduce this excess demand since the buyers of the public sector assets are not likely to reduce their demand for the goods and services. When public sector equity is sold, it only replaces money in a capitalist's hands, upholding their claim upon the government. It is of no consequence whether the money is monetised by the central bank or financed by the sale of government bonds. Hence, the government selling an asset makes no difference to fiscal deficit. However, the sale is not accounted as a fiscal deficit due to ideological reasons, propounded by international institutions which favour privatisation.

According to the argument made by Prof. Prabhat Patnaik, fiscal deficit is a skewed way of financing government expenditure not because of the neoclassical 'crowding out' argument but because it increases wealth inequality in the economy. Once money is placed in private hands through a fiscal stimulus, it automatically implies either a direct or indirect claim upon the government, made by private players. It does not matter if the debt is monetised by the central bank or raised through sale of government bonds. The cause of the capitalists' claim on the government is the fiscal deficit itself which causes a part of the deficit generated output to land on the capitalist's lap as profits which they now hold as savings. A more equitable way of financing the deficit instead could be a tax financed deficit through introduction of profit tax and wealth tax.

Literature Review

Pre Keynesian theory believed that fiscal deficit causes crowding out of private investment as the magnitude of savings in the economy is assumed to be fixed. Hence, drawing more savings towards the government would leave less for the private sector, causing a fall in private investment via a rise in interest rates. The dependence of savings on income was never accepted by the

'treasury view' (Das 2004). This is because the economy is always assumed to be at full employment, which makes the pool of savings fixed at S*

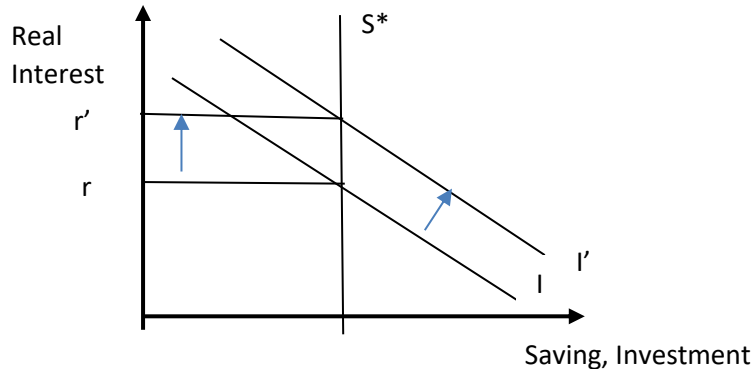

Figure 1

The figure above shows a vertical savings curve at the level of full employment with fixed savings. A rise in government investment does not cause output adjustment but increases interest rate from r to r' causing crowding out of private investment.

However, today's economic situation is largely defined by demand constrained conditions. Therefore, in a demand constrained economy, operating below full employment, there is reason to believe that output adjustment takes place through various rounds of multiplier. This will cause income and savings to increase with equality in savings and investment in an ex-post sense. Even if there are conditions of full employment (as propounded by neo classics), prices in the economy would rise, causing changes in distribution of income and forced savings instead of interest rate adjustment (Das 2004). Similarly, a sophisticated version of the treasury view which takes both savings and investment to be a function of interest rate advocates for partial crowding out. (Figure 2). Increase in government spending shifts the Investment curve outward. However, instead of r'', interest rate rises to r'. This view also takes the level of income given even though savings and investment are both functions of r. In an economy below full employment, output adjustment takes place and Y also increases causing excess savings in an ex-post situation. Therefore, there is no reason to believe that fiscal deficit would cause a rise in real rate of interest and crowd out private investment to maintain ex post savings-investment equality in a demand constrained economy.

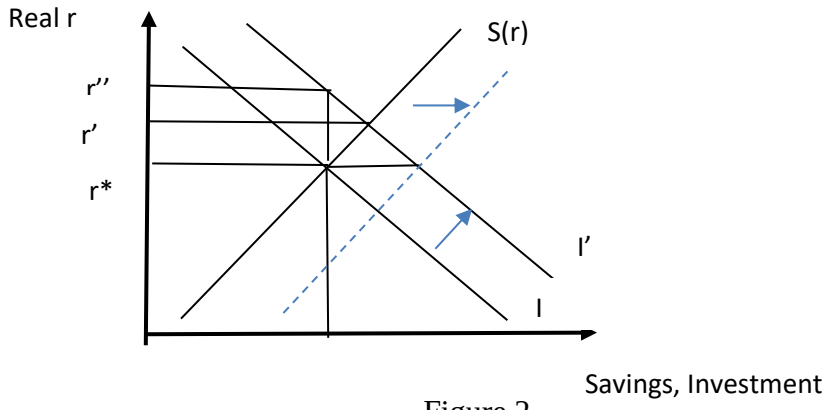

Figure 2

If savings were considered to be both a function of r and Y, then fiscal deficit would also increase the saving curve to the right at the same rate of interest. Therefore, crowding out does not necessarily take place.

In a demand constrained economy, fiscal deficit causes not just output adjustment but given excess capacity of credit creation, money demand also increases. The supply of money increases to meet this surge in demand and the interest rate does not rise. Now, when the government borrows from the market to finance its budget deficit, supply of government bonds increase causing a fall in bond price and rise in interest rates. The RBI in its Report on Currency and Finance for the year 2002-03 discussed how the demand for government securities reached a saturation point with a warning that any further rise in government borrowing would cause interest rates to rise. However, such beliefs are based on the assumption that the total demand for securities is given. However, a fiscal deficit not only increases the supply of securities but also their demand, i. e. it shifts both the demand and supply curves outwards.

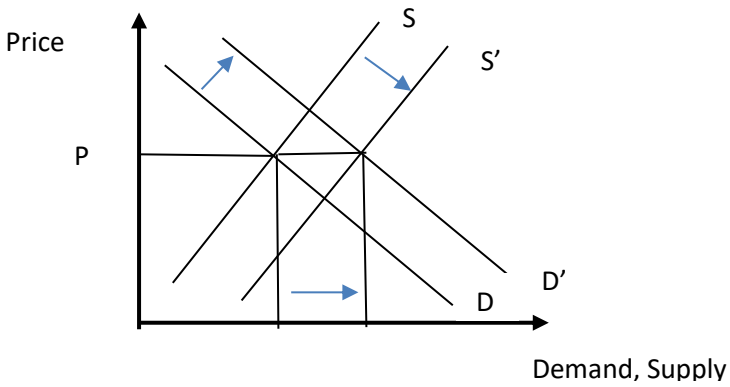

Figure 3

The demand and supply of government bonds settle at price P. An increase in supply of government bonds without an increase in corresponding demand will cause the price to fall. However, if demand for government securities increases with an increase in supply, the price of government securities will remain at P.

One of the major advancements in economic theory has been the development of the theory of endogenous money. According to Minsky, the interest rate is administered by the central bank – "to keep interest rates at a given level, the central bank must be willing to supply reserves to commercial banks, in response to commercial banks' demands, without limit at a fixed rediscount rate. Therefore, the rediscount rate seems the appropriate tool of central bank policy" (Minsky 1957). The theory of endogenous money is based on the premise that as income increases, people's deposits with commercial banks also increase (causing a rise in the savings pool); the increase in demand for money is met by an increase in money supply by banks. Basil Moore (1988) has also made similar contributions in the field of exogenous money which is credit led and demand determined. "The money supply may be regarded as horizontal" (Moore 1998); it meant that even if there was a fall in supply of credit with respect to its demand, the banks will have to meet this

excess demand by digging into their reserves/resorting to call market operations to maintain their credibility. In the present scenario of policy determined interest rates, it can be said that there is no supply of money function. Supply is determined by demand (Lavoie 2001).

Das (2010) shows that the PLR moves significantly parallel with the policy determined exogenous bank repo rate even under a "non-administered interest rate regime". This shows that interest day is policy determined i.e., outside of the realm of money demand and money supply equality. The banks have a higher than mandated SLR and in the event of demand surge, the SLR is liquidated. In the Indian context, even during the high growth period between 2003-04 and 2007-08, the commercial banks were able to finance a substantially higher credit demand at the ongoing interest rate just by liquidating government securities. Hence, there is no reason to believe that interest rates would rise due to increase in demand for credit. The value of money multiplier and velocity of circulation of money may adjust over time according to the demand for money. This story has not changed even post the 2008 financial crisis.

The general macroeconomic belief has been that high fiscal deficit reduces capital formation in an economy, both by a fall in private investment (crowding out) and reduction in public investment (as government consumption expenditure rises) (Economic survey, 2001; Report of Economic Advisory Council, 2001). Additionally, it is also said that high fiscal deficit also poses debt-deficit sustainability issues for the economy, with high structural primary deficits and interest payment adversely affecting economic growth (Rangarajan and Srivastava 2005). However, studies have found a complementary relationship between public and private investment (Ramirez,1994), Greene and Villanueva,1990), Buiter, 1977), Aschauer, 1989), and Erenburg, 1993)). The Ricardian equivalence theory suggests that the fiscal deficit of the present period will be equal to the future value of taxation. This will cause an increase in household savings as households foresee this rise in future taxation, causing an overall rise in national savings. This will offset an increase in interest rate, leaving investment demand unchanged (Barro, 1978, Ghatak and Ghatak, 1996, Bahmani Oskooee, 1999). Therefore, fiscal deficit will not increase aggregate demand if household spending falls taking into account future tax liabilities (Rangarajan and Srivastava, 2005).

According to Samuelson and Nordhaus (1989) "the most serious consequence of a public debt is that it displaces capital from the nation's stock of wealth" and "private capital is displaced by government debt" (p 403). Therefore, as supply of government bonds increases, people's holding of other assets falls as total wealth holding is fixed for a given rate of interest. The authors place an assumption of full employment which leads them to conclude the above results. However, even on allowing such an assumption, the only thing that can be said conclusively is that private per capita holding of productive capital falls. The effect on aggregate per capita capital stock depends on the composition of government expenditure and if the government debt is used to finance accumulation then the per capita steady state capital stock will in fact remain unchanged (Das, 2004).

Role of State and social rationality

One of the premises of the Keynesian revolution was that in a capitalist economy, if all economic agents behave rationally (i.e., optimised on some given objective function), the overall

outcome would be irrational (i.e. cause unutilized capacity and unemployment). Keynes emphasized that fiscal deficit in a demand constrained economy, with unemployed labour and unutilized capacity raised the level of income and increased savings. State intervention, therefore, was advocated to uphold social rationality. For the state to carry out this function, it had to prevail unconstrained, external to the private sector.

If the state has to carry out socially rational functions, then it has to be non-imitative of private agents i.e. the same rules of debt accumulation that apply to private agents cannot apply to the state. This is because the state, unlike private agents, enjoys taxation powers. Hence, making the state fiscally responsible makes it constrained to private rationality (Patnaik 2017), constraining capitalist economies to achieve social rationality and overcoming involuntary unemployment. If overcoming unemployment is a Pareto improvement, then why is finance capital opposed to fiscal expansion by state? This is because pursuit of social rationality by state threatens the legitimacy of finance capital and related financial interests. As Kalecki explains in his Essays (1971), "The social function of the doctrine of 'sound finance' is to make the level of employment dependent on the 'state of confidence". The role of nation states is subverted to serve the interests of finance capital and independent fiscal actions by the state are considered 'illegitimate', requiring controls under the humbug of finance.

Monetary policy has been a popular policy response by sovereign states over recessionary tendencies. The motivation with which monetary policy is followed also gives the impression that the solution for involuntary unemployment lies with the central banks which has larger political economic implications for finance and capital. However, the failure of monetary policy in solving the most pressing economic problems cannot be overlooked. The developed world (US and Europe) had near zero interest rates for around a decade now with the result that it has made finance more 'footloose' rather than solve the problem of involuntary unemployment or economic recovery. The lack of inflation among developed economies further project that there is a demand deficit in the economy, most likely to be corrected by output adjustment than price adjustment. This also explains Keynes' thoughts from The General Theory, 'there are many a slip between the cup and the lip' which captures the imperfection in interest rate transmission which becomes insufficient to recoup and economic recovery in the absence of active state intervention. This highlights the role of expectations in business cycles and the major role played by prospective yield in determining investment levels in the economy.

Analysis of the Study

The Indian economy was already grappling with historic levels of unemployment and severe economic downturn even before the pandemic hit. The Central Government Expenditure as a percentage of GDP has been reducing from 15.1 percent in 2018-19 to 13.2 percent in 2019-20 (Ghosh and Chandrashekhar, 2020). Why is the government spending less in a demand constrained situation? The answer lies in fiscal conservatism. Ghosh and Chandrashekhar analyse the flawed procyclical policy of the government which causes it to fall into a negative spiral. A slowing economy generates lesser than expected tax revenue. In the absence of a stimulus to boost the purchasing power of the people, the obsession with fiscal deficit ensures that government expenditure cannot be maintained at a higher level and this leads to curtailment in transfers, social

sector spending and sectoral spending on agriculture, MSMEs etc. Meanwhile, neoliberal policy prognosis such as corporate tax cuts in a demand constrained situation only lead to pocketing of the profits by the business houses. Tax cuts do not lead to higher private investments by corporations as the demand for goods is too low. On the other hand, the loss of revenue causes severe fiscal strain and slashing of social sector spending to maintain deficit targets. However, even with decreased Central Government spending, the fiscal deficit of the government increased from 3.4 percent (2018-19) to 4.6 percent (2019-20) because of the 'paradox of thrift'.

Empirical evidence on fiscal deficit and crowding out in the Indian context have been few and mixed. Using asymmetric vector autoregressive models on Indian data for the period 1970-71 to 2002-03, Chakraborty (2006) shows that there is no evidence of direct crowding out of private capital from public capital formation in India; rather complementarity between the two kinds of investment exists. Similarly, a RBI (2002) study also talks about public infrastructure investment crowding in private investment. Fiscal consolidation began in India post liberalization causing deficits to decline from 7.8 percent of GDP in 1990-91 to 4.84 percent of GDP in 1996-97 (Raju and Mukherjee 2010). The FRBM Act was introduced in 2003 against the backdrop of high fiscal deficits in 2001-02, mandating reduction in revenue and fiscal deficits by 2009. However, post the 2008 economic meltdown, the central government followed a policy of expansionary fiscal policy, cutting taxes and increasing expenditures. It is often believed that resource expenditure imbalances can be detrimental for developing economies such as India, affecting macroeconomic fundamentals, raising interest rate and crowding out private investment. Below, we analyse data from 1990-91 onwards for the Indian economy.

The Covid-19 situation sparked a huge debate about the size of the fiscal stimulus India received as part of its 'atmanirbhar package'. The biggest argument against a fiscal stimulus package comes from India's own economic history over the past few decades. The most obvious and extreme example is the borrowing spree unleashed by the central government in the late 1980s which culminated in the economic crisis of 1991, forcing a rapid and painful course correction. India was inducted into the fragile five economies with widening fiscal and current account deficits post the 2008 crisis (due to fiscal and monetary easing). The central government's fiscal deficit hovered around the 5 percent mark even as the consolidated fiscal deficit averaged about 7 percent in the fiscal years 2012 and 2013. Foreign investors pulled out of emerging markets in anticipation of inflated yields. Therefore, it becomes evidently clear that fear of capital flight becomes the major reason for practicing fiscal conservatism among developing countries. Any trigger of capital flight causes volatility in exchange rate of rupee, impacting trade balance, hence globalized finance rules the policy roost in developing countries.

It becomes evidently clear that globalized finance is averse to developing countries following an independent fiscal policy and comes up with 'rule-based fiscal targeting' as well as 'sovereign credit ratings' to prevent autonomous fiscal policy. In fact, there has been a fall in central government spending.

Attracting foreign investment ultimately becomes a redundant exercise if the countries are not able to utilise it for their developmental purpose. India currently has a historic high of 533.103 billion dollars of foreign reserves but our fiscal stimulus (as a percentage of GDP) has been the lowest among the G20 countries. These are the rules which finance imposes for parking itself in

host countries, threatening to trigger an economic crisis if it were to pull out. According to Erinc Yeldan, in the neoliberal era, wages have stagnated, and investment levels have fallen despite historic levels of profits earned by large corporate (UNCTAD TDR 2018). These stagnant wages have caused a fall in purchasing power among people all over the world and led to a crisis of demand. However, even when the problem is that of demand, the prognosis continues to be supply side with tax breaks to big corporation houses being a popular policy response. However, the accumulated savings of the corporates aggravate the problem of underinvestment as lack of demand among people prevents capital investment, increasing economic inequalities.

Concluding remarks

The fact that finance is globalized while the State remains a nation-State, ensures that the writ of finance runs; and this strips contemporary capitalism of any potential instrument for achieving even a semblance of social rationality (Patnaik 2017) The opposition to globalized finance is the only way in which nation states can follow individual fiscal policies and correct for economic recovery. The objections to an expansionary fiscal policy in the Indian context cannot be considered without taking into account the ideological hegemony backing globalized finance. It is in this context former Greek Finance Minister, Yanis Varoufakis advocates for an economic democracy over and above the political democracy (which is already achieved by nation states). Economic democracy ensures the use of finance for independent developmental purposes, using the vast liquidity injection in the global economy to solve the most pressing issues of mankind (hunger, climate change) as opposed to parking it in developing countries and imposing subsequent conditionalities under the pretext of ‘reforms’. In this paper, we have succinctly argued for an expansionary fiscal policy which go against the principles of ‘sound finance’ but are necessary to ensure economic recovery in demand constrained economies.

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