The fiscal myth

Slow growth in the last few quarters, with growth in GDP dropping to 5.7% in the June quarter, has led to widespread speculation that the Central government might resort to increased spending to boost the economy. While there has been no official announcement of a fiscal stimulus yet, both the Finance Minister and Chief Economic Adviser have confirmed that the government is looking at ways to revive the economy. Many have justified the idea saying that in the absence of sufficient help from a hawkish Reserve Bank of India, the Central government is right to take things into its own hands.

However, the argument that government spending can revive the economy and put it on a high-growth path is based on weak economic logic. Support for aggressive fiscal stimulus measures usually comes from the belief that it can put more money in the hands of citizens, thus spurring them to spend and boost demand in the economy. This is the famous Keynesian “multiplier effect” that economists talk about as a tool to counter economic downturns. Apart from the fact that citizens do not necessarily have to spend the money they receive from the government, the logic of fiscal spending is found wanting on various other levels.

For one, contrary to Keynesian orthodoxy, insufficient demand is often not the primary reason behind an economic slowdown. Instead, it is only the side effect of production shocks, like the chaos induced by the implementation of the goods and services tax (GST), that cause the income levels of people to drop and, in turn, affects their ability to spend. Fiscal stimulus does nothing to address the root of the problem, which is disruption in production rather than insufficient demand. Two, fiscal spending is a zero-sum game, wherein resources are misallocated from their original use towards other ends. Taxes that the government collects to spend on the economy, for instance, come out of the pockets of citizens who would otherwise spend it according to their own tastes. Such taxes also weigh negatively on an economy that is already reeling under the impact of other disruptions to production. On the other hand, when the government borrows from the credit markets to fund its spending habits, it distorts the spending and saving decisions of citizens. Even when additional fiscal spending is funded out of thin air, for instance through deficit spending funded by the central bank, the misallocation of resources is unavoidable. Three, while fiscal spending is praised for its ability to employ idle resources, it should be remembered that it also impedes the movement of such resources towards more productive employment. In fact, fiscal spending can artificially prolong a recovery by delaying economic adjustment.

In order to foster genuine recovery, the government must undertake pro-market reforms that can help the economy quickly recover from the shocks of demonetisation and GST. Anything less will only expose the Centre’s inability to carry out tough economic reforms.

The new U.S. Fed Chairman is unlikely to opt for policies that might upset the President’s plan

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