Fiscal push is needed now, not later

India's quarterly GDP (gross domestic product) growth declined for the sixth consecutive quarter in the three months ended 30 June. Since the first quarter of last year, growth rates have been 9.2%, 7.9%, 7.5%, 7.0%, 6.1% and 5.7%. These cannot be explained only by temporary disruptive factors like demonetization or destocking prior to the roll-out of the goods and services tax (GST). Nor can this steady decline be explained solely by global conditions.

Other key indicators also corroborate this longer-term decline. Fixed capital formation as a share of the GDP has been declining for five years. Credit flow to industry has been drying up. This of course is a manifestation of the twin balance-sheet problem, namely over-leveraged corporates, and stressed bank loans. The big picture is that from a spending and demand-side perspective, all four drivers of growth are sputtering. Private investment spending (as evidenced by fixed capital formation) is growing at barely 1.6%. Exports have grown only about 1.2% last quarter. Consumer spending growth, normally a reliable and consistent driver, has dropped to 6.6% from 8.6% a year ago. Even government spending which grew at 20% last year has slowed down.

This is a head scratcher. If macro context is conducive, in terms of moderate inflation, stable currency, plentiful inflows, soaring stock markets and a reasonably low fiscal deficit, and a normal monsoon, why then is growth declining? Are the lingering effects of demonetization more severe than anticipated? Are high interest rates the main culprit? Is consumer confidence dipping for some other reasons? Are exports hurting because of the strengthening rupee?

Whatever may be the proximate causes, in light of the fact that all four demand drivers are losing steam, this is a prime case for a fiscal stimulus. That's because the other three demand drivers will take time to energize. Exports will gather momentum mainly when our destination economies do better, and also with some help from rupee depreciation. Private investment spending will need healthier and less leveraged balance sheets, and improvement in capacity utilization. Private consumption spending will need improvement in sentiment, confidence and evidence of higher incomes and job growth. It is thus government spending which can provide a quicker boost. This age-old Keynesian wisdom is still relevant. Monetary measures like reducing interest rates take time to have an impact on economic growth, due to delays inherent in imperfect transmission.

Fiscal consolidation has been one of the prized achievements of the present government. The gains from falling oil prices did not lead to a spendthrift budget. This year the budgeted fiscal deficit of the Central government is 3.2%, which will fall further to 3**%** in the following year. The expert committee on FRBM (fiscal responsibility and budget management) too has recommended bringing down the fiscal deficit to 2.5% by 2023, and also cap the debt to GDP ratio at 60%. But as the dissent note in that FRBM report observed, mindlessly sticking to numerical targets can be pro-cyclical, i.e. make a slowdown worse. In a downturn, tax revenues decline, which necessitates cutback in government spending to achieve the fiscal deficit target.

This makes the downturn worse. That is why a downturn should allow higher deficits, which are then compensated in boom times. The FRBM report does recognize such exigencies and provides for an exception, or escape clause. But that condition is too stringent—it says GDP growth has to drop by 3 percentage points sharply compared to recent average. Such a steep fall is a huge macroeconomic shock. Instead it is better to achieve fiscal discipline ratios over an entire cycle of boom and bust. The growth rate of 5.7% is indeed 3.5 percentage points lower than 9.2% achieved five quarters ago, but is not sharply lower as compared to recent average. But it is better not to be the proverbial frog in the slowly boiling water.

The 3% fiscal deficit holy grail number has origins in the number agreed by the European Union in

the Maastricht treaty, there is no theoretical basis for this. For a country with a young demography like India, the number of unborn taxpayers far outnumbers the currently alive taxpayers. So passing a lighter per-capita tax burden on future unborn generations, through a higher fiscal deficit, is much more feasible for India than Europe. India is a developing country which is bound to have higher debt and deficits. It is also amusing to note that the earliest violators who breached the Maastricht ceiling were the largest economies of Europe, i.e. France and Germany. In the course of the European debt crisis, even the International Monetary Fund recommended abandoning fiscal austerity.

India needs to expand fiscal spending in at least three specific sectors: (a) affordable housing, through interest subventions and assistance to states to acquire contiguous land to provide to developers. This can be potentially a big booster; (b) subsidy to employers, by way of full funding of pension funds or part of wage payment of workers and apprentices. This was done in a limited scale in the package announced for textile sector last year, but can be expanded to other labour-intensive sectors; (c) enhanced fiscal support to manufacturing and services exports schemes.

The downside of this fiscal policy is a possible threat to India's international rating. Given that India's rating has been anomalous, if not unfair (as pointed out by the government's chief economic adviser), this is hardly a reason to forebear. The positive and immediate impact on growth will outweigh the costs of the fiscal boost.

Ajit Ranade is chief economist at Aditya Birla Group.

Comments are welcome at views@livemint.com

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