Who's Afraid of the Fiscal Deficit?*

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The ongoing review of the Fiscal Responsibility and Budget Management Act 2003, by a Committee set up by the central government, has once again brought to the fore the vexed question of whether limits should be set by law to the government's fiscal practices. More particularly, the issue being considered is whether the rigid fiscal deficit and current deficit targets set by the FRBMA are either meaningful or desirable in the contemporary economic environment.

There are many reasons to be willing to reconsider the FRBMA. While strict rules for limits on public debt and the fiscal deficit (either in absolute terms, as in the US, or as a share of the GDP, as in the European Union) became something of the global fashion around two decades ago, thereafter there is greater recognition of its negative effects and scepticism about its positive impact. Fiscal consolidation and austerity with regard to public expenditure remain the knee-jerk reactions of policy makers in countries across the world, as well as international organisations like the IMF in its policy advice to most developing countries, yet the justificatory evidence for such reactions is thin on the ground.

Indeed, the behaviour of the global economy as well as the that of most economies at present is up-ending many conventional dogmas of the mainstream economic policy framework. Globally, we have now experienced the longest ever period of incredibly loose monetary policies, with huge amounts of liquidity creation in the form of "quantitative easing" as well as near zero interest rates, yet the inflation that was threatened to result as a consequence is nowhere in evidence.

Yet the unbalanced over-dependence on monetary policy is now showing up to be less and less effective in generating recovery. Countries that responded to the crisis of 2008 with expansive fiscal policy (such as the US) were the ones that recovered faster and in a more sustained way; others – most economies – that relied only or dominantly on loose monetary policies are still largely floundering in the depressing "new normal" of low or stagnant growth and poor employment generation.

But even apart from recent global experience, the naysayers with respect to rigid fiscal rules have valid points. To start with, the decision to limit the deficit to a particular ratio – most commonly 3 per cent of GDP, following the EU's Maastricht Rules – has no particular sanctity, and no really plausible theoretical or empirical analyses have been provided to justify it. A similar concern exists with respect to rules on public debt to GDP ratios, as these ratios vary widely across countries without showing the predicted macroeconomic effects. The rules have also been pilloried for being excessively procyclical, and thereby accentuating business cycles by adding to booms and prolonging and deepening slumps. A greater concern may be the contribution they make to prolonged economic stagnation.

In the Indian case, various other definitional and practical problems have plagued the implementation and the impact of the FRBMA. The Act calls for zero revenue deficit of the central government and reaching a 3 per cent limit on the aggregate fiscal deficit (thereby to be made up only of capital expenditure).

However, the ways these are defined in the central budget mean that some expenditures that are for capital spending are defined as revenue spending of the Centre. For example, all grants made to State governments, even for clearly capital spending like the Pradhan Mantri Gram Sadak Yojana, are classified as revenue spending of the Centre. Conversely, all loans made by the Centre to the States are classified as capital spending, even if they are actually for revenue expenditure purposes, such as power sector loans that enable banks to write off the losses of the State Electricity Boards.

While this may make sense in purely accounting terms (since capital expenditures are seen as those that bring some return, while revenue spending does not) it makes a mockery of the economic distinction in such spending. In any case, this economic distinction itself can be hard to justify. Given the huge social and developmental value of much revenues spending, particularly that related to food and nutrition, sanitation, education, health and so on, it is hard to argue that such spending generates no social return and therefore should somehow be seen as less deserving of some deficit spending than capital spending.

However, one of the biggest practical problems that the FRBMA has generated is something that has also been noticed in other countries – that of increasing the propensity of the government to evade it by simply cheating. In other words, by making various expenditures “off-budget” through Special Purpose Vehicles and other such devices, a lot of expenditure can be simply removed from the central government Budget.

The Indian government has proved to be adept at another and possibly much worse form of cheating, by simply holding back on necessary payments to public enterprises and government programmes. The MNREGA has been one of the worst sufferers from this ridiculous tendency, with huge backlogs of central government dues to state governments in each year, in the past year coming to more than Rs 6,000 crore. Since this reduces the funds available with the States for this programme, it has also affected its functioning, in a completely unacceptable way.

Similarly, the Food Corporation of India suffers from massive delayed payments, that affect its profitability and even financial viability, and then lead to calls for restructuring it or even closing it on grounds of “inefficiency”. Many other state-owned enterprises and public programmes suffer from attempt of the central government to fudge its books so as to appear to be approaching the FRBMA rules without actually adhering to them.

This blinkered approach does much more damage than simply creating opacity in the public accounts and rendering them less transparent. It also has very adverse effects on the public programmes and enterprises that are so affected, which in turn has possibly long run consequences on the economic and social indicators that such spending was designed to improve.

However, another consequence – or should we say lack of consequence? – of such cheating calls into question the very foundations of the argument for the FRBMA. And so it is surprising to find that this point is barely made in the discussions surrounding this Act. Essentially, it amounts to a complete rebuttal of the case for fiscal responsibility, at least in terms of its practical implications.

It is generally argued that fiscal limits are necessary for two reasons: to prevent or reduce "crowding out" and to reduce inflationary tendencies. The first stems from the argument that government borrowing causes market interest rates to rise and thus crowds out private investment activity. The second argument can be made from two different directions, monetarist and Keynesian. The monetarist argument is that the fiscal deficit represents credit creation and therefore excess money supply in a context in which the real demand for money is given, which in turn must lead to inflation in the economy. The Keynesian argument is that fiscal deficits results in aggregate excess of expenditure over income in the economy (which in turn assumes no change in the private surplus/deficit), which must then spill over into either balance of payments deficit or domestic inflation.

Obviously, both arguments are based on assumptions that can be questioned. But the real issue is: how have these processes played out in practice, in the recent Indian experience? Here, the obvious – but under-noticed – point is that larger than declared fiscal deficits have had neither of these anticipated adverse effects! Not only have the fiscal targets promised under the FRBMA not been met, but the actual fiscal deficits have been significantly greater than those that have been declared. Yet there is no evidence of "crowding out" at least for large investors (credit always remained severely rationed in India for small enterprises). Nor is there any evidence of enhanced inflationary pressures resulting from these excess and undeclared fiscal deficits.

This very fact surely should give pause to those swearing by these deficit targets as essential for macroeconomic stability and growth. The targets clearly can have adverse consequences in terms of heightened cyclicality and reduced potential growth. But adherence – or lack of adherence to them also do not appear to make much difference to the macroeconomic indicators that are supposed to be directly affected.

Surely this basic realisation should prompt a more comprehensive rethink of the unquestioned acceptance of such fiscal rules?

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