Decentring the Fiscal Deficit Target Numbers

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Nations, unlike households, do not face budget constraints. Fiscal deficit targets therefore cannot be the objective of macroeconomic policy. Instead, budget discussions must focus on governance, supply-side bottlenecks and on policies to raise aggregate demand.

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From popular newspapers to business dailies and television channels, the one economic issue that hits us hard and repeatedly, 24/7, is the dire need to contain the government's fiscal deficit. Every year, as the day of the government's budget announcement draws near, concerns over India's fiscal deficit only intensify. For instance, prior to this year's budget presentation the first page of a leading business daily (Hirschler and Kumar 2015) unequivocally declared:

> "Current fiscal deficit level *unacceptable*: Jaitley"[1]

Let me quote a few lines from the front-page article (Hirschler and Kumar 2015) because it succinctly captures the growing urgency and fear, desperation perhaps, over the fiscal deficit that takes the form of definitive numbers like 4.1%, 3.6%, or 3% of gross domestic product (GDP).

> Government *will not stray* from plan *to slash* fiscal deficit to 3% of gross domestic product, finance minister says.
> The Government *is scrambling to contain* the fiscal deficit at 4.1% of GDP in the fiscal year ending March, after *a sharp downfall* in revenue that forced it to *rein in* spending. The fiscal deficit *touched* Rs 5.25 trillion, or 99% of the full year's deficit *target*, in November (Hirschler and Kumar 2015, emphasis added).

But below such decisive posturing, it seemed that the government was struggling to find some space for manoeuvre—to increase spending without recourse to excessive cuts in expenditures.

> The government's top two economic advisers, Arvind Panagariya and Arvind Subramanian, have both advocated *loosening* deficit targets *to allow* public spending on infrastructure to jumpstart economic growth.
> Prime Minister Narendra Modi and Jaitley seem determined to spend more on roads and railways but, despite the views of their advisers, *without breaking deficit commitments*. The three top credit ratings agencies place India on *the lowest rung* of investment grade for its debt (Hirschler and Kumar 2015, emphasis added).

In response, one of India's leading economic commentators forewarned the government of harbouring any such hopes.

> Jaitley *must stick* to the path of consolidation ... reducing the fiscal deficit to 3.6% and 3% of GDP in the *next two years* ... Arvind Panagariya ... made the case for *living with* higher fiscal deficits to finance urgently needed infrastructure. *Sorry*, but that would *seriously dent* Jaitley's fiscal *credibility*. To establish a *tall reputation*, he *absolutely must stick* to his fiscal reduction *schedule* (Aiyar 2015, emphasis added).

With such strong views constantly bombarding us, there seems to be little room for debate over this fixation with a fiscal deficit target. Numbers like 4.1% or 3.6% do not arise from macroeconomic theory. In fact, one wonders where they come from. For example, Bimal Jalan, former Governor of the Reserve Bank of India (RBI), who heads the Expenditure Management Commission, recommended that the fiscal deficit be cut to 3.6% in 2015–16 (Press Trust of India 2015), while Arvind Panagariya, well-known liberal economist and adviser to the government, stated rather casually after the budget of 2014–15 was presented in July 2014 that, "in an economy where you are trying to push up the growth rate, a fiscal deficit of 4.5% (of GDP) *is fine*" (Bose 2014).

In popular economic discourse, across the world, the government's fiscal deficit is often equated to a household spending beyond its means, living off the private sector's hard-earned money. The likely outcomes of such irresponsible behaviour are: (i) the government accumulates debt and in the process also "crowds out" private sector investment. Moreover, this debt burdens future generations who have to service and repay this debt; (ii) the government "prints" money and when this money is not spent "productively" it causes inflation, which is really nothing more than a tax borne by the private sector. Such a narrative obviously elicits an adverse response to fiscal deficits.

The Post-Keynesian Approach

The sectoral financial balance (SFB) approach provides an alternative perspective of the macroeconomy and the fiscal deficit, which opens up critical policy space for the government. Unfortunately, it still remains outside mainstream economic thinking in the West, while there is relatively little reference to it in India, both within academia as well as in popular economic discourse. This brief commentary takes a peek into the SFB equation, which counters popular paranoia over the fiscal deficit.

Derived from the basic principles of double-entry bookkeeping, the SFB equation states that:

$$(G_0 - T) = (S - I_0) + (M - X_0) \qquad ...(1)$$

where

G_0, I_0 and X_0 are exogenous and S, T, and M are endogenous (function of the level of income, Y).[2]

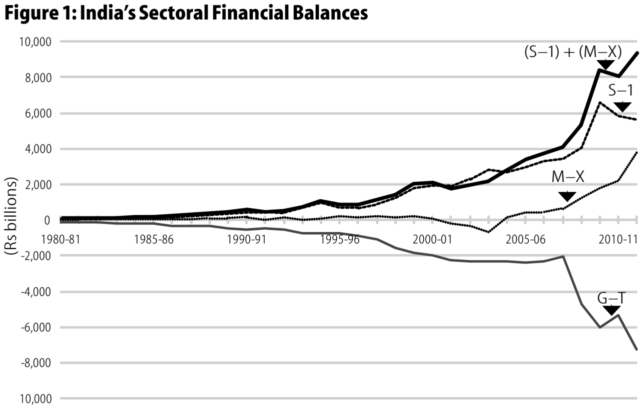
For a country with a trade deficit[3]—for instance India—equation (1) requires that for a positive net domestic private sector financial savings ($S > I$), the government *must* run a fiscal deficit ($G > T$). The SFB equation highlights the fact that there cannot be *net* positive financial savings exclusively within the private sector as a whole; if households borrow money from a bank, households (the bank) have (has) a liability (an asset). If households lend money to a firm, households (the firm) have (has) an asset (a liability). Assets cancel out liabilities so that there cannot be net financial savings in the private sector alone. For net positive savings in the domestic private sector (i e, for $S > I$) we need a deficit in the government sector ($G > T$), assuming $(M - X) > 0$.[4]

Implications of Deficits

To understand the implications of government deficits, consider a situation where $M = X = I = 0$. The SFB equation then implies that at an equilibrium level of income, we must have $G_0 - T = S$. When the government spends or makes injections more than it taxes (a fiscal deficit), the domestic private sector is left with surplus state money or net financial assets (liabilities of the government) that is equal to the government deficit. If the government instead spends less than it collects through taxes (a fiscal surplus) then the only way for the domestic private sector to pay their taxes in state money is to dip into their earlier stock of net savings (wealth) so that they end up as net dissavers or net debtors.[5] The domestic private sector, unlike a government, cannot sustain perpetual financial dissaving (or accumulate debt)—in order to achieve their targeted net positive financial savings level it is likely that the private sector will at some point increase its marginal propensity to save (or reduce their marginal propensity to consume), triggering an economic recession. The level of GDP would then fall, forcing tax collections to decline so that the government ends up with a deficit or at least a balanced budget. Only then will the private sector have net financial savings which are also ≥ 0.[6] It is therefore useful to ponder over the possible consequences of *slashing* the budget deficit, or undertaking austerity measures, on private sector financial savings.

In Figure 1, I have attempted to construct sectoral financial balances for the Indian economy.[7] It exemplifies the fact that financial balances of the three sectors of the economy must balance although it does not establish the direction of causality, i e, which sector *causes* the other to align itself to meet equation (1).

Figure 1: India's Sectoral Financial Balances



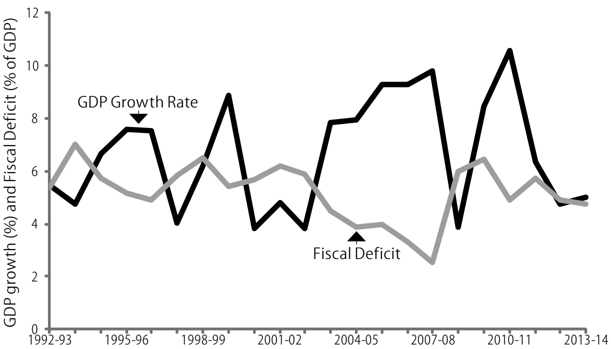
Consider a situation where the government runs a deficit with the non-government sector (domestic private + foreign) running a surplus as in equation 2 (along with some hypothetical numbers that might be considered as percentages of GDP).

$$\begin{array}{ccccc} (G_0 - T) & = & (S - I_0) & + & (M - X_0) \\ 3 & = & 2 & & 1 \\ >0 & & >0 & & >0 \end{array} \quad .....(2)$$

What happens if the government changes its objective and cuts spending to G_1 attempting to force a fiscal surplus? All else constant, this could result in something like equation (3):

$$\begin{array}{ccccc} (G_1 - T) & = & (S - I_0) & + & (M - X_0) \\ -3 & & -2 & & -1 \\ <0 & & <0 & & <0 \end{array} \quad ...(3)$$

Figure 2: Comparing GDP Growth and Fiscal Deficit



It is also possible, however, to have an outcome as in equation (4),

$$\begin{array}{ccccc} (G_1 - T) & = & (S - I_0) & + & (M - X_0) \\ -3 & & +1 & & -4 \\ <0 & & <0 & & <0 \end{array} \quad ... (4)$$

Equation (4) may, however, be less feasible because such a drastic fall in imports may come about only with a massive contraction in GDP. Moreover, under a flexible exchange rate mechanism, the trade surplus would induce an appreciation of the domestic currency, causing exports to fall.[8] If we instead remain with equation (3), the government's budget surplus implies domestic private sector dissaving or rising private sector debt, which is unsustainable over a longer period. As mentioned above, if the domestic private sector wants to reverse dissaving into net positive savings, it has to increase its marginal propensity to save thereby slowing down the economy. This would in turn have adverse repercussions on tax collections—the country would reach equilibrium but at the cost of a contraction in GDP.

This simple logic of the SFB equation is evident when we observe that historically, governments almost always end up with budget deficits, not surpluses.[9] Figure 1 shows this to be true for India; a fiscal surplus having never being realised in the last 35 years. In spite of this simple tenet of modern money, the "fiscal deficit" and "public debt" (net private sector wealth) are derided.

Moreover, while there is heated debate on whether a fiscal deficit of 4.1% or 3.6% of GDP is acceptable or not for India, what is missed is that this is only a target; the outcome is ultimately non-discretionary. Figure 2 clearly illustrates this fact for the Indian economy. The government can only set the level of its expenditures and tax rates. Actual tax collections will depend on the level of income (or profits) of economic agents—this cannot be set by the government. When an economy experiences a boom (recession), then for any given level of expenditure, tax collections will be buoyant (depressed) so that the fiscal outcome will be a higher surplus or lower deficit (higher deficit or lower surplus). The fiscal outcome, therefore, acts as an automatic stabiliser during booms and recessions.[10] Given the non-discretionary nature of the fiscal deficit, it is futile to make arbitrary numerical targets the primary focus of fiscal policy per se.

Conclusions

Post-Keynesians categorically assert that sovereign nations[11] that issue fiat currencies operating under a flexible exchange rate regime do not face a solvency issue. The state is not like a household—it is the issuer and not the user of state money and therefore does not face a budget constraint. Fiscal deficit targets cannot be the objective of macroeconomic policy—the actual fiscal deficit is non-discretionary. The constraint to government spending is the productive capacity of the economy; excessive spending will result in inflation and a depreciating exchange rate. It is imperative then that discussion around the "budget" focuses on issues pertaining to governance in order to alleviate supply-side bottlenecks or on policies that seek to raise aggregate demand in an economy rather than a fiscal deficit target number. It is time that the Indian government recognises the immense policy space available to it as a sovereign nation and does not succumb to unnecessary constraints imposed on it by rating agencies and media hype.

So why are myths about the need to balance budgets propagated by the economics community? One possible answer is what Samuelson once mentioned to Mark Blaug:

> I think there is an element of truth in the view that the superstition that the budget must be balanced at all times [is necessary]. Once it is debunked [that] takes away one of the bulwarks that every society must have against expenditure out of control. There must be discipline in the allocation of resources or you will have anarchistic chaos and inefficiency. And one of the functions of old fashioned religion was to scare people by sometimes what might be regarded as myths into behaving in a way that the long-run civilised life requires (qtd in Wray 2010).

But should we therefore throw the baby out with the bathwater?

NOTES

1 Italics used throughout the Introduction are mine for emphasis.

2 This is akin to the Keynesian income-expenditure model where at equilibrium level of income we must have I + G + X = S + T + M.

3 M > X implies net inflow of foreign capital or net foreign savings in the domestic economy.

4 Capital inflows resulting in foreign sector net financial asset accumulation.

5 While deficits and savings are flow concepts; their stock equivalents are debt and financial wealth respectively.

6 This can be illustrated with a simple example: Let $C = 100 + 0.75Y$, $G_0 = 50$ and $T = 0.2Y$. For $G_0 - T = S$ we must have $Y = 375$, $T = 75$ and $S = -25$ with a marginal propensity to save at 0.25. If the private sector savings are not satisfied with their dissaving (running down its financial assets) and aim at (at least) zero savings it would have to increase mps to 0.5. However, with this change equilibrium level of income would fall to 250, tax collections fall to 50 and $(G_0 - T) = S = 0$.

7 India does not publish sectoral financial balances as per the classification we need to use here. This is available only for the advanced countries in which case the financial balance of the government is an exact mirror image of the non-government (domestic + foreign) sector financial balances. The data we have used for our construction are from different sources and for more recent years we find only estimates (not realised). Nonetheless, we can observe a strong inverse pattern between the financial balance of the government and non-government sectors.

8 Some countries like Norway are able to meet equation (4) with large trade surpluses so that they run budget surpluses along with positive net domestic private sector savings.

9 This is true of almost all major economies in the world including the United States of America, the United Kingdom, Japan, Australia, and even Germany. The former US President Bill Clinton managed to realise a budget surplus, which was, however, followed by what Wray calls a "perfect fiscal storm" (Wray 2011).

10 Austerity measures during recessions are supposed to revive an economy in recession. However, when the government spends less than it collects as revenues the private sector ends up with a deficit, consumption falls and with it GDP. This leads to low tax collections and a fiscal deficit outcome setting off a new round of austerity measures. Not surprisingly on the opposite page of Aiyar's (2015) article there were reports on how the anti-austerity movement is gathering support in Spain following the victory of Alexis Tsipras in Greece.

11 Members of the European Union are not sovereign in this sense; they cannot issue fiat currencies and are in fact budget constrained. They are more like state governments or municipal corporations.

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