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ECONOMY

Will the Fiscal Stimulus Package Put the Indian Economy Back on Track?

BY SASHI SIVRAMKRISHNA ON 26/09/2017 • LEAVE A COMMENT

Fiscal policy is a potent instrument that must be used to alleviate the unemployment crisis, but first, supply-side constraints need to be systematically united.

A cashier stacks Indian currency notes inside a bank in Chandigarh, India, November 19, 2016. Credit: Reuters/Ajay Verma/Files

I vividly recall watching an interview with Paul Krugman in which he remarks that being a macroeconomist soon after the 2008 global financial crisis was like being an undertaker during a famine – business was good. As a teacher of the subject, I cannot but agree, even though it sounded rather insensitive to the victims of a famine. Until the crisis, macroeconomics was more like a course on economic history; most Keynesian theories seemed relevant to the Great Depression of the 1930s. It was difficult to satisfy the students' constant demand for "real world examples" and contemporary ones at that. Then came the crisis and everyone was eager to study macroeconomics – what went wrong, how would the world overcome it. But as the US and the world, including India, slowly recovered from the crisis (at least the visible economy), the enthusiasm to study recessions and depressions once again began to recede, at least in the classroom.

The economic slowdown in India before the 2014 elections was seen as an aberration attributable to corruption and poor governance of the UPA government. Then came demonetisation (https://thewire.in/tag/demonetisation/), followed by the implementation of the Goods and Services Tax (https://thewire.in/tag/gst/), which have sent the Indian economy spiraling downwards (https://thewire.in/172710/indias-gdp-growth-slows-5-7-june-quarter/) and at the same time, rekindled interest in

macroeconomics amongst students. And over the last week, just as I began discussing the simple Keynesian model, students could relate it to the real world where fiscal stabilisation policy was unfolding in sync with my course! The popular macroeconomics discourse, however, often glosses over some insights gained in classroom discussions that I want to share here.

It is now common knowledge that the growth of all the components of India's aggregate expenditure – consumption, private sector investment spending, net exports – have been slowing down sharply in Q4 of FY 2017 (https://www.bloombergquint.com/business/2017/05/31/india-gdp-economic-growth-gva-slows-due-to-weakness-in-construction-and-finance-segments), except government spending. Growth rate in personal final consumption expenditure slowed down from 11% to just over 7%, investment growth was down by 2%, while recent figures show a widening in the current account deficit (http://www.livemint.com/Money/ULoweDmw7Bb1vEIEuR7IqM/Current-account-deficit-widens-to-24-of-GDP-in-Q1-shows-R.html)to 2.4% of the GDP in Q1 of the current fiscal year. More significantly, the rupture on account of the GST has begun taking a toll on exports; recent reports suggest (http://www.rediff.com/business/report/gst-woes-rs-65000-crore-worth-of-exports-may-get-stuck/20170920.htm)that some $10 billion worth of export orders have taken a hit. While the government may argue that the slump in the GDP growth to 5.7% in Q1 of this fiscal (as compared to 7.1% in Q1 of the last fiscal) may only be a temporary anomaly, there is now a growing fear that we may have slipped into a lower growth trajectory. Denial over demonetisation as the cause of this dismal scenario is simply unconvincing.

In such a situation, direct government spending can provide a direct boost to the GDP growth, at least in the short-term, especially in an economy plagued by surplus capacity across several sectors (https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/OBICUS010820172F06A2C9E6EB438CA2812C080B6F49DB.PDF). Moreover, the benefits of increased government spending on the GDP growth come with a multiplier effect; the crucial question that immediately follows is the value of the multiplier. In a 2013 working paper of the National Institute Public Finance & Policy

(http://www.nipfp.org.in/media/medialibrary/2013/09/WP_2013_125.pdf), Bose and Bhanumurthy estimated the capital expenditure multiplier to be 2.45 so that "an increase in capital expenditure by the government by Rs 1 crore would raise the GDP by Rs 2.45 crore by the end of the year, where both are measured in nominal terms." Assuming that inflation does not accelerate, the expected fiscal stimulus package of Rs 40,000 crore will therefore raise real GDP by about Rs 1 lakh crore over the next 12 months. Given that India's GDP is around $2 trillion or Rs 130 lakh crores, the stimulus will result in an impetus to real GDP growth by 0.75% or in other words, an increase from the present growth rate of 5.7% to about 6.5%, all else constant.

In another interesting working paper of the International Labour Organization (ILO), Sinha *et al* have estimated (http://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_policy/---invest/documents/publication/wcms_426060.pdf) Type I and Type II multipliers from additional demand in various infrastructure sectors for Gujarat and West Bengal. The Type II multipliers which are closer to the Keynesian multipliers taught in the classroom are as high as 5.8 and 7.6 for Roads Construction (both urban and rural) in Gujarat and West Bengal respectively. This implies that a one rupee increase in demand for roads will lead to Rs 5.8 and Rs 7.6 increase in demand for output across sectors in each of the states. Assuming these figures hold good for the whole of India, this would mean a massive boost to the GDP growth by more than 2% from the anticipated fiscal stimulus package.

More than raising the GDP growth rate, the objective of the contemplated fiscal stimulus package is generating employment. Once again the figures of employment multipliers are rather staggering; for Gujarat Type I and Type II employment multipliers for Rural Road Construction are as high as 2.6 and 5 respectively, whereas for West Bengal, the numbers are approximately three and eight respectively, although a significant portion of the jobs created (approximately 90%) would be for informal workers. A multiplier of three means "that to increase output of rural roads construction by Rs 100,000, three additional workers per day over one year are required". Now, if the GDP growth rate were to increase by the estimated 2% (from the Type II expenditure multiplier), then six crore jobs can be created.

If all this could happen with a Rs 40,000-crore increase in the government's capital expenditure, we could easily solve India's most pressing economic problems, in particular, unemployment. What then are the limitations of these multiplier estimates?

A fiscal stimulus can also raise imports and induce a further deterioration in our already worsening current account position. Credit: Reuters

Before answering this question, it is important to dispel an important obsession over the fiscal deficit target of 3% of GDP. The present fiscal stimulus, if implemented, is likely to mean a breach of this year's target of 3.2% by 0.3% so that we may end up with a 3.5% of GDP fiscal deficit. Economists and rating agencies have already begun issuing warnings over deviating from the path towards fiscal consolidation. As I have argued earlier (here (https://thewire.in/121017/modern-money-obsession-fiscal-consolidation/) and here (http://www.epw.in/journal/2015/19/commentary/decentring-fiscal-deficit-target-numbers.html)), a fiscal deficit of 3% is as arbitrary a figure as 2.5% or 3.5%. If the fiscal stimulus package is successful in reviving real GDP growth and generating significant employment, then the deficit number simply does not matter. Moreover, the deficit is ultimately non-discretionary and even works as an automatic stabiliser; as GDP growth accelerates, tax collections turn buoyant and the deficit will contract for any given level of government spending. At a time when the world

acknowledges the failure of fiscal austerity (for instance, here (https://www.theguardian.com/business/ng-interactive/2015/apr/29/the-austerity-delusion) and here (http://unctad.org/en/PublicationsLibrary/tdr2017overview_en.pdf)), it does not make sense for India to follow it blindly at this juncture.

Returning to the large multiplier numbers discussed above; they are both a boon and a bane. While they do indicate the efficacy of a fiscal stimulus in generating demand for output and employment, the problem lies in whether or not aggregate supply can respond quickly enough to these highly amplified increases in demand. Widespread sectoral supply-side constraints would immediately result in accelerating inflation and a smaller increase in real GDP than can be expected from the multiplier figures *per se*. Moreover, a fiscal stimulus can also raise imports and induce a further deterioration in our already worsening current account position.

It is useful to understand the fiscal stimulus transmission mechanism. Suppose the government spends Rs 100,000 on building a new rural road. The first step here would mean an increase in the order book of the contractor-firm. Nominal GDP increases by the amount spent by the government. The contractor-firm may then place an order for (say) Rs 20,000 on another firm for (say) asphalt. If the asphalt producer has surplus capacity, the output will be forthcoming so that real GDP increases. Similarly, if there is surplus labour available, the contractor-firm and asphalt producer can employ people at the going wage rate. The employed persons would then spend on various consumer and wage goods, triggering off a positive chain reaction that yields a multiple (Type II) increase in output or real GDP and employment across various sectors of the economy.

In reality, however, the multiplier process may not pan out quite this way. The contractor-firm may obtain raw material supplies but may not be able to obtain the necessary amount of labour possessing the right set of skills. While the output multiplier may be activated on account of increased production of asphalt, the project can stall even as wage rates begin to increase (due to lack of available labour supply), setting off a wage-price spiral in different sectors with supply bottlenecks. In fact,

such endemic supply-side constraints could bring the multiplier process to a premature halt. The economy ends up with a higher price level but without the increase in real output as anticipated from multiplier estimates. It is no surprise then that a more realistic figure of the employment multiplier is something like one million jobs for a 1% increase in GDP growth (http://timesofindia.indiatimes.com/business/india-business/slow-gdp-growth-casts-shadow-on-job-mkt/articleshow/60772062.cms).

At the macroeconomic level, the constraints on the multiplier process get accentuated so that more than increases in real output, inflation rears its ugly head. But the issue must be clearly delineated; it is neither the fiscal deficit nor fiscal stimulus which is inherently problematic, for as we have seen, it does have the potential to raise aggregate demand, output and employment. Instead, the problem lies in the ability of aggregate supply keeping up with rising demand. But if capacity utilisation rates are indeed as low as they are at present, then why is there so much apprehension in implementing the fiscal stimulus package?

The answer is the series of supply-side structural shocks that the economy has been put through in the recent past. It began with the disrupting demonetisation exercise, followed by a rushed implementation of the GST (that was earlier touted as a positive structural reform), continually increasing domestic oil prices (https://thewire.in/177415/petrol-price-narendra-modi-government/), a credit and banking crisis on account of mounting non-performing assets (https://thewire.in/133484/banking-regulation-act-ordinance/), the disruptions in the informal sector as well as the socio-economic unsettling of rural markets. Expansionary fiscal policies may have helped the economy a few years ago – especially at a time when international oil prices afforded a sufficient cushion on the import front – instead, the government chose austerity and fiscal consolidation. Fiscal expansion at a time of repeated and massive supply shocks, a burgeoning current account deficit combined with an imminent increase in US interest rates that would induce dollar outflows could result in the Indian economy drifting into stagflation.

Neoliberal economists have, therefore, been arguing that the solution to the present economic predicament is structural supply-side reform, disinvestment in public sector companies combined with interest rate cuts by the Reserve Bank of India, while at the same time, cautioning the government not to go astray from its path of fiscal consolidation and adherence to the target fiscal deficit of 3% of the GDP. Many supply-side reforms are no doubt beneficial to liberating industry from unnecessary constraints; however, in the present context, they seem like nothing more than attempts to push the economy to a higher growth trajectory with a feeble piece of string.

Meanwhile, there are major lessons from the impending crisis that we can learn for the longer-term. Given the values of the multipliers, fiscal policy is a potent instrument that must be used by the government in alleviating India's massive unemployment crisis. At the same time, a lot depends on governance wherein the structural supply-side constraints that are endemic across sectors in the Indian economy need to be "systemically" untied – beginning with education and healthcare. It is these constraints that successive governments are unable to surmount and have instead, at the behest of neoliberal economists and rating agencies, been judging their success – unquestioningly accepted as common sense in popular discourse – in terms of adhering to some imaginary and arbitrary fiscal deficit target number (here (http://www.livemint.com/Politics/jhqKGY7cfgteYOtQJw3TyN/Union-Budget-201617-Arun-Jaitley-sticks-to-fiscal-deficit.html), here (http://www.thehindubusinessline.com/economy/budget/fiscal-deficit-target-of/article8295608.ece) and here (http://www.business-standard.com/article/economy-policy/govt-sticking-to-fiscal-deficit-target-a-big-relief-economists-116030700004_1.html)).

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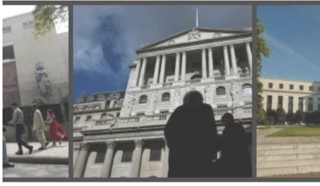

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