A deficit myth

Student Research Internship Report

Rashi Gulati

July 2023

A Deficit Myth

Rashi Gulati[1]

Introduction

Economic theory and governmental policy have long engaged in heated discussion about the fiscal deficit. According to conventional wisdom, maintaining a fiscal deficit is a risky course that will cause financial instability and leave future generations with an unmanageable debt. Modern Monetary Theory (MMT) proponents, however, argue against this conventional viewpoint, claiming that a government's capacity to issue its own currency profoundly changes the dynamics of fiscal policy. By examining the fiscal deficit myth through the MMT perspective, this article hopes to clarify its tenets and dispel common misconceptions about this divisive economic theory by analysing the fiscal deficits of United states over the past two decades.

Fiscal deficit

When a government's spending exceeds its income in a given fiscal year, it faces a fiscal deficit and must borrow money to make up the difference. The governmental debt often rises as a result of this borrowing. Fiscal deficits have historically been viewed with skepticism by economists and decision-makers due to concerns about how they might affect interest rates, inflation, and the long-term viability of governmental finances.

---

[1] The author is a student at NMIMS, Bangalore. This article was written as part of the author's research internship at Foundation to Aid Industrial Recovery – Macroeconomic Analysis and Policy Studies. I, Rashi Gulati, declare that the contents of this article have not been plagiarized by me. The views expressed in this article are mine.

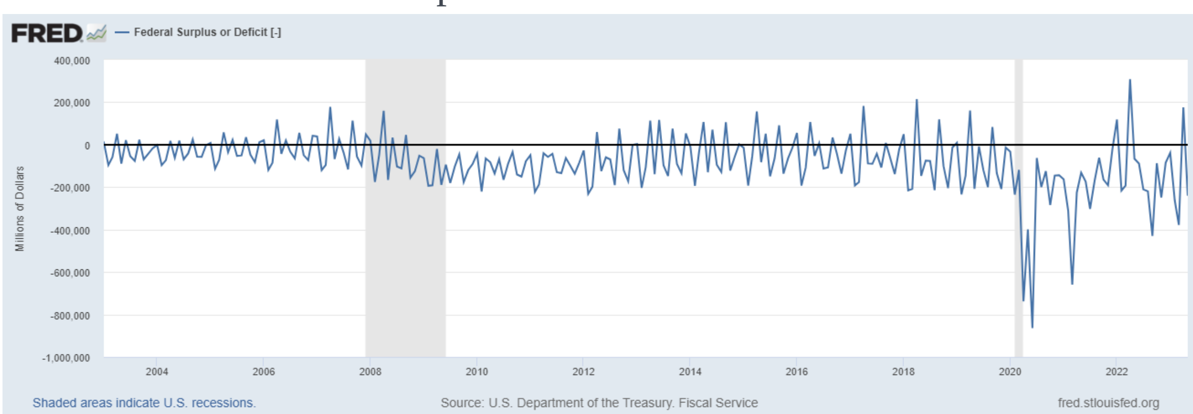
MMT and the fiscal deficit

MMT is an economic theory that challenges the conventional thinking about fiscal deficits, government spending and the role of money in the economy.

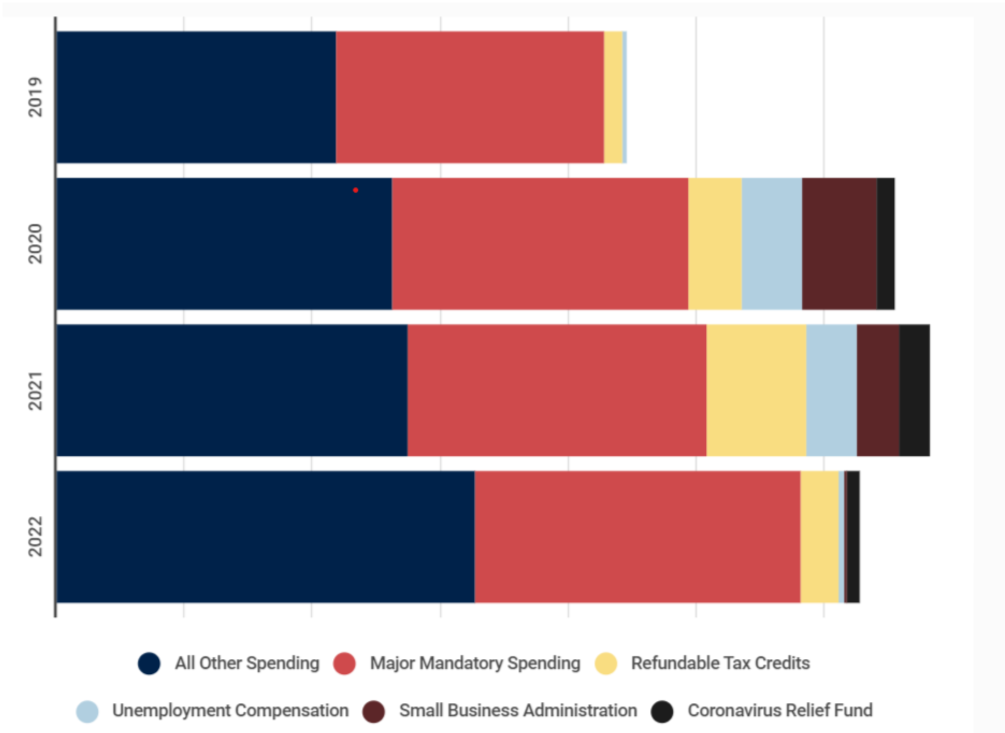
In the conventional theory, it is believed that government issues taxes and uses it for their expenses. To pay, the rest of the expenses it borrows money which lead to the budget deficit in the economy. We cannot consider government debts as same as the household debts and the idea that government will go bankrupt if it doesn't pay back the loans are absurd. Government can always pay back their debts by printing our own currency and this is the most important view of MMT that the government is sovereign.

Analysis on United states fiscal deficit-

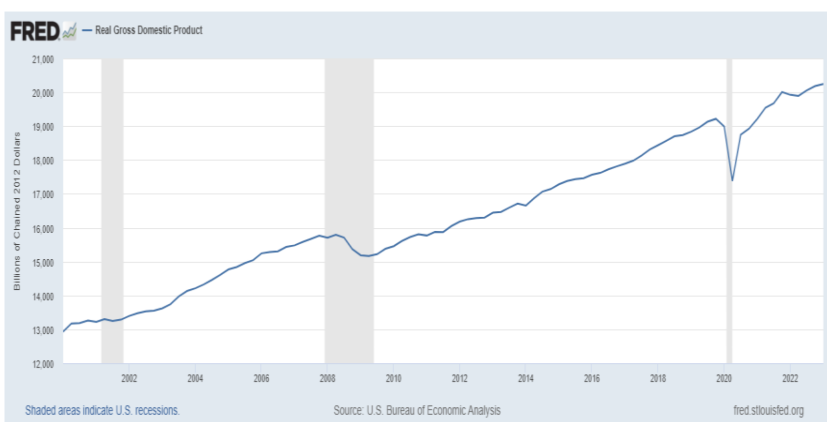
United states has experienced fiscal deficit since 2001.



From this graph we can infer that since two decades it has constantly been under deficit with highest during covid 19 period. The federal government faced fiscal deficit of $3.1 trillion in 2020 which was triple the deficit of 2019. It ran a deficit of $1.4 trillion in 2022 which was half the deficit in 2021.



Through this graph we can see that the spending of the government increased during the period of 2020-2021 which became a cause of increase in the deficits. From Covid-19 pandemic we can understand that the government can finance their expenditure through issuing currency without going bankrupt.



From this graph we can see that debt to GDP ratio of US has increased over the years specifically in 2008 financial crisis and during pandemic. During recession, we can expect the debt to GDP ratio to increase as GDP rate becomes low as compared to the debt. At that time, the targets set by the government such as 60% debt to GDP ratio becomes quite meaningless. As the country recovers from recession, the ratio becomes low without letting the country to go bankrupt.

MMT and taxation

According to Modern money theory, the government can issue its own currency to settle down debts and to finance expenditure and it does not require taxes to finance its expenditure. So why does government issue taxes? It is because it is a tool to control inflation. As we know when with taxes, the government can control the aggregate demand in the economy which will in turn control the inflationary pressures in the country.

Inflation: A comparative analysis of 2008 financial crisis and Covid-19 pandemic.

Inflation is the sustained increase in the general price level in the economy and it is one of the crucial factors affecting any economy. As from the graph, we can see that after 2008 financial crisis the inflation rate was not as high as after the covid-19 pandemic. So why inflation became an issue after the pandemic?

The following factors may have contributed to it-

Aggregate demand-

After 2008 crisis, there was a decline in aggregate demand as consumers and business reduced spending due to financial uncertainty and reduced business confidence. But after the pandemic, the aggregate demand in the economy increased for vaccines, travel and hospitality. Increased in demand with disrupted supply led to the increase in inflation after the pandemic.

Supply chain disruptions-

Pandemic caused a great supply chain disruptions in the economy as due to lockdown and restrictions on the movement of goods which was further a reason for the inflation after the pandemic.

The major findings indicate that the COVID-19 problem appears to have caused 1.4 times more economic harm than the 2008 financial crisis. Several policy implications for COVID-19 flow from all of this. First, the historical levels of financial support programs by the central banks and governments in significant nations will be upheld in light of the enormous economic harm caused by the COVID-19 crisis. The downstream industries (such as those in the automotive, electrical, and metals industries) should also receive more financial aid because they must pay more for products and consequently experience greater economic losses.

In summary, modern money theory offers a distinctive viewpoint on macroeconomics and fiscal policy. MMT questions the prevailing conventional view and has prompted a number of discussions on how the government should manage the economy. The media's focus on the fiscal imbalance does not provide a fuller picture of how government sovereignty functions.

On the other side, critics raise questions about the sustainability of ongoing deficits as well as inflationary pressures. Through MMT, we gained a more comprehensive understanding of how taxes function to curb inflationary pressures and how deficits do not burden future generations, which gives the theory's detractors a better justification. This article provided a concise explanation of how money creation and fiscal policy works.