

## The government must adopt expansionary fiscal measures in Budget

A revival of strong growth will automatically check the deficit through higher tax collections

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Even in the best of circumstances, predicting what the economy may look like in the future is a tenuous exercise. Doing so in the present context, with the Omicron threat lingering, makes it all the more questionable. There are reports that the pandemic will turn endemic and if this happens, life may more or less return to normalcy. This may be a contentious assumption, but we need to begin somewhere.

A useful way of looking at the overall macroeconomy is with the sectoral financial balances (SFB) equation developed by the economist Wynne Godley, which states that net financial asset accumulation (NFAA) across the external sector, the government and domestic private sector must net to zero. If one sector is accumulating net financial assets, then at least one other sector must be accumulating net financial liabilities. This equation is drawn from double entry bookkeeping and must hold good, although it does not establish causal relationships.

When the pandemic struck in April 2020, India's GDP plummeted and with it, domestic private sector NFAA (private sector savings less private sector investment spending) rose significantly from 6.3% of GDP in FY 2019-20 to more than 14% of GDP in FY 2020-21. This huge increase in domestic private sector NFAA was accommodated by a general fiscal deficit (government accumulation of net financial liabilities) of 13.4% of GDP plus external accumulation of net financial liabilities (India's current account surplus) of 0.9% of GDP.

The estimated figures of the general fiscal and current account deficit for FY 2021-22 are close to 11% and 1.5% of GDP respectively. This means NFAA in the current financial year by the domestic private sector will still be at some 9.5% of GDP, although significantly lower than the levels in the previous financial year. The reduction in NFAA has come about by a significant increase in private sector investment spending. However, given that growth in private sector final consumption spending remains tepid, implying the propensity to save remains high on account of the uncertainties unleashed by the pandemic, the private sector NFAA continues to be at an elevated level compared to pre-pandemic levels.

Going forward into the next financial year, 2022-23, if the government adopts austerity policies that are aimed at significantly reducing its spending and consequently, the targeted fiscal deficit, then growth must come through greater leveraging (a reduction in NFAA) by the domestic private sector. An improvement in consumer confidence could possibly mean an increase in consumption

expenditure (reduction in savings ratio) as well as increased investment spending. However, if the accumulation of financial liabilities (fiscal deficit) by the government remains higher than the NFAA by the domestic private sector, the balance NFAA must be by the external sector (current account deficit).

The best-case scenario for India would be rapid leveraging by the domestic sector that drives growth, but at the same time keeps the fiscal deficit in check, not by a reduction in government spending, but instead through buoyant tax receipts. At the same time, sustained growth in exports is necessary so that high GDP growth does not allow the current account deficit to widen from a likely increase in imports.

There are some major challenges to the best-case scenario actually emerging. A lot depends on a strong and robust revival in private consumption expenditure. This will also be a significant factor in determining capacity utilization by industry and therefore, domestic private sector investment spending. In a situation where the desire for NFAA by the private sector remains high (poor leveraging), this will have to be accommodated either by the accumulation of net financial liabilities by the government (larger fiscal deficits) and/or in the external sector (larger current account surpluses). For any given quantum of government spending and exports, tax collections and imports must be lower, a situation which implies slower GDP growth.

There are other global issues that will impact the Indian economy in the coming months: inflation rates in other major economies, the US Fed's interest rate hikes, continued supply-side disruptions and oil prices. A more pessimistic outlook on these will mean the possibility of higher domestic inflation and consequent interest rate hikes by the Reserve Bank of India, two factors that can dampen the possibility of increased domestic private sector leveraging.

The strong plausibility of such a situation playing out will have to be pre-empted by the government brushing aside austerity measures in the forthcoming budget and instead adopt expansionary fiscal measures to support domestic private sector consumption and investment demand. As we know, the fiscal deficit is an automatic stabilizer and a revival of strong growth will automatically check the deficit through higher tax collections. At the same time, supportive fiscal measures will prompt a greater quantum of leveraging by the private sector, which in turn will contain the desire for NFAA by the domestic private sector.

Although the SFB equation allows for a stock-flow consistent analysis of the economy, it does not answer several other questions on the economy that remain outside its scope including the dismal employment scenario. Nonetheless, the broad performance of the Indian economy at a macroeconomic level is a necessary, if not a sufficient condition, for a robust reduction in unemployment rates.

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***Views are personal and do not represent the stand of this publication.***