Will Government Spending on Food Security Spike 'Twin Deficits'?

Surajit Das

It is being argued that the food security bill will give rise to an increase in the fiscal deficit as proportion to Gross Domestic Product (GDP), which is already near 8 per cent. This increase in fiscal deficit, in turn, may widen the current account deficit (i.e. import minus export of goods and services less the remittances) of balance of payments, and cause the rupee to fall further. This argument is not only farfetched but also misleading and erroneous.

The historic food security act finally saw the light of the day in September last year. Incidentally, US dollar has also become more expensive vis-à-vis the Indian rupee since its value rose from Rs.45.58 per US$ in 2010-11 to Rs.47.92 per US$ in 2011-12 and further to Rs.54.41 per US$ on an average during 2012-13.

Monthly and daily data of RBI suggest that the exchange rate will not be less than Rs.60 per US$ in 2013-14. A 33 per cent depreciation of currency within three years is huge and undoubtedly alarming. It is being argued widely in the media that the food security bill (or 'fiscal profligacy' in general) would necessarily give rise to an increase in the fiscal deficit as proportion to Gross Domestic Product (GDP), which is already near 8 per cent (taking Central and State governments together). It is also being argued that this increase in fiscal deficit, in turn, may widen the current account deficit (i.e. import minus export of goods and services less the remittances) of balance of payments, (which reached historic peak of more than 5 per cent of GDP during 2012-13) and cause the Rupee to fall further down. However, none of the above-mentioned causal linkages are necessary. In fact, larger government expenditure is needed today to revive the growth rate, which has become lower than 5 per cent in the recent past (according to revised estimate, 4.5 per cent in 2012-13 and 4.9 per cent in 2013-14 by advanced estimate). Let us try to elucidate the argument step by step.

Firstly, even if the aggregate government expenditure rises because of implementation of National Food Security legislation, as the nominal GDP is also rising (growth in GDP at constant prices plus the inflation), it is not necessary that the government expenditure would go up as a proportion to GDP. The expenditure to GDP ratio would go up if and only if all the other expenditures taken together, apart from the additional expenditures due to food security expenses, grow at the same growth rate in which the GDP at current prices is growing. For example, if the indirect subsidies to the big industries in terms of tax concessions come down as proportion to GDP[1] , the additional expenditures in social sector can easily be accommodated, given any expenditure-GDP ratio.

Secondly, even if we assume that the expenditure-GDP ratio would rise, the fiscal deficit to GDP ratio would still not rise unless the revenue-GDP ratio of the government either remains constant or comes down. But there is no reason to believe that the revenue of the government cannot go up as proportion of GDP. In fact, in India, including Central and all the State governments, we have one of the lowest tax-GDP ratio (of 16 per cent of GDP for Central and all the State governments taken together) in the entire World[2]. According to the IMF data, we stand 163rd out of 189 countries for which data is provided in World Economic Outlook database of 2013. Given any revenue buoyancy greater than one, in a growing economy like ours, the tax-GDP ratio must rise.

Thirdly, even if we assume that after all our tax efforts and strengthening of tax administration and widening the information network and collection of non-tax revenues etc., the fiscal deficit still rises as proportion to GDP due to rise in expenditure, it is not necessary that the current account deficit in balance of payment has to go up as proportion to GDP. The national income identity tells us that the fiscal deficit must always be identically equal to the current account deficit plus the excess of saving over private investment. The current account deficit would necessarily go up with an increase in fiscal deficit only if we assume that the saving-investment gap cannot rise more than or equal to the rise in the fiscal deficit. But there is no reason to believe why it can't. Even if, for the sake of argument, we believe that the saving-investment gap rises less than the rise in fiscal deficit, the current account deficit as a proportion to GDP would rise if and only if the current account deficit rises at a higher rate than the nominal GDP. Most importantly, if the government spends more than it taxes, i.e. if it incurs a fiscal deficit, the disposable income of people rises simply because people would earn relatively more income in aggregate and they have to pay less tax. The moment the government spends some money, it becomes somebody's income in terms of either wages or salaries or other factor incomes. This enhanced disposable income (i.e. net income after tax), in aggregate, can either be saved or be spent either on domestically produced goods or on imported goods.

It is unrealistic to assume that the entire additional income would only create extra demand for importable and would not be saved or be spent on domestically produced goods at all. The enhanced purchasing power of people would also raise the aggregate demand for domestically produced goods and services in the economy, which, in turn, would cause aggregate output to grow using unemployed labourers and unutilised capacity in demand constrained situations. This enhances the income and purchasing power further and the process continues for several rounds. The total effect on aggregate income for per unit change in government expenditure is known as the 'government expenditure multiplier' in the literature of Economics. What is more, as part of the additional income would be taxed, this increment in aggregate income raises the tax revenue of government, too. Therefore, it is not necessarily follow that any increase in social sector expenditure will worsen the current account balance as proportion to GDP. If 75 per cent of rural poor and 50 per cent of urban poor get basic foodgrains at cheaper rate, their real purchasing power would go up, given their income and level of consumption. By the way, we are talking about the people whose incomes are really low; they are not expected to save too much; neither would they demand a lot of imported commodities nor would they be taxed heavily. A large proportion of their income will be spent on consumption of domestically produced goods and services. If they demand more domestically produced commodities other than foodgrains, then domestic production of those commodities would also increase.

In the presence of large scale unemployment and unutilised capacity, there is no reason to believe that there would be only price adjustment and no quantity adjustment on the supply side or there would be no increase in output. The industries, which produce those non-food items, would generate additional incomes in terms of wages, rents, profits and other factor payments, which again would be either consumed or saved (or taxed or imported). The government expenditure multiplier (as mentioned above) starts functioning and the multiplier is much stronger in this case because the marginal propensity to consume (i.e. extra consumption out of per rupee of enhanced income) is very high for the poorer masses. Obviously, part of the consumption expenditure might be on imported commodities and some industries might use some imported inputs in their process of production. Now, if the exchange rate deteriorates, these imported products become costlier (e.g. oil) – this may have (cost push) inflationary implications. But, there is no reason to believe that the entire additional demand would necessarily be leaked out by import surplus and expansionary fiscal policy would be completely ineffective in raising domestic level of activity in non-full employment and non-full capacity situation.

There is another effect of the exchange rate depreciation – from the point of view of the foreign investors; the expected rate of return reduces in real terms. Even if the expected rate of capital gains on a share be 19.37 per cent in 3 months in Indian share market and if the exchange rate becomes Rs.66.25 per USD from Rs.55.5 within that period (as has happened during June, July & August, 2013), then the rate of return in terms of USD would be 0. However, as the exchange rate depreciates, by the same logic, exports become more rewarding because by exporting 1 dollar worth of commodities in the international market, the exporters will earn more money in terms of domestic currency. It is worth mentioning here that import is considered to be dependent on the national income of the importing country. In real terms, the GDP of India is growing at a much faster rate than GDP of our main export destinations, particularly following the financial crisis. Since, the growth rate of our export is dependent on (along with other factors) their economies' growth rates, the trade deficit is likely to be widened. Plus, the unprecedented rise in international oil prices caused yawning of the current account deficit of large oil importing countries like ours. If the net capital inflow is not sufficiently large to cover the current account deficit, the exchange rate would start depreciating. The Central Bank can and should manage the exchange rate deprecation temporarily by releasing more dollars from its foreign currency reserves to match the excess demand for dollar. But this process cannot go on forever. Now, if the rupee starts falling very sharply, India becomes less attractive as destination for foreign investment. As a result, the net capital inflow comes down and the domestic currency depreciates more sharply. This is a vicious cycle.

There are two ways to handle the situation. One is by putting more restrictions on imports (other than oil or essential inputs) and by promoting exports in new destinations i.e. by reducing the trade deficit along with Central Bank intervention in exchange rate management. The other is by having more openness and faster reforms (as pointed out by former finance minister Chidambaram) or by desperately attracting more foreign capital at any cost – even at the cost of inviting FDI in multi-brand retail, in national defence, in insurance and pension even in financing the fiscal deficit. "What we need now, according to the minster, "is not less reforms but more reforms; not more restrictions but less restrictions; not a closed economy but a more open economy" (*The Hindu,* August 28, 2013. Parliament Speech, August 27, 2013). The first option goes against the philosophy of so-called 'globalisation-liberalisation' and hence, for not so obvious reasons, our government is banking only upon the second option and making the economy more dependent on the mercy of international finance capital.

The crisis in trade account has not been caused by the high fiscal deficit of the Central and State governments. It has happened because of many other reasons like crisis in the developed World (as mentioned above - disparities in growth rates), hike in international price of oil, huge import of Gold for investment purposes and so on. In fact, the reverse causality seems to be more prominent – i.e. large trade deficit is depressing GDP growth (because of leakage of aggregate demand through huge import surplus) and as a result of that the government revenue collection would suffer and fiscal deficit is likely to go up as proportion to GDP even if the expenditure-GDP ratio does not rise at all. Moreover, if the government tries to reduce government expenditure in order to bring down the fiscal deficit on the face of demand deficiency caused by high current account deficit, the growth rate would come down further and unemployment situation could get aggravated.

> *The economy is not characterised by excess demand but rather by a deficiency of aggregate demand; it is not excess demand that is the cause of the yawning current account deficit but rather it is the yawning current account deficit that is the cause of a deficiency of aggregate demand; it is not excessive government expenditure that is*

creating excess demand pressures in the economy but rather it is the largeness of the government expenditure that has till now acted as a counterweight to the deficiency of aggregate demand; it is not so much an improvement in the current account deficit that a curtailment in government expenditure will bring about but rather a further reduction in the growth rate of the economy through an even greater slump in aggregate demand (with only a marginal fall, if at all, in the current account deficit). (Patnaik 2013, PD).

Obviously, finance capital favours smaller government intervention and opposes expansionary fiscal policy and Central Bank intervention in exchange rate market etc. Our government is also committed to improve the credit rating of India as a preferred destination of international finance capital in order to balance the widening current account gap by larger and larger foreign capital inflows. In this context, if 70 per cent of our poor vulnerable population gets some cereals at cheaper rates due to the National Food Security legislation, accusing that for larger depreciation of currency is grossly unfair and hence, disturbing.

Even if it is 'vote security bill' (as pointed out by the Opposition in Parliament) rather than a Food Security Bill, given the dynamics of our democracy, I support it (apart from some minor technical points) in the interest of 70 per cent of our population. The so called 'populist' policy measure does not necessarily mean 'bad Economics'. In fact, in my view, the ongoing fiscal conservatism resulted from fundamentalism of 'sound finance' in the interest of finance capital and big businesses (forgetting the interest of common people) are rather bad Economics. The investor's confidence, anyway, depends on the policy measures, which favours them by giving guarantee for more profit in the name of creating 'congenial environment for businesses'. Therefore, any attempt of holding the required government expenditure for implementation of National Food Security Act (or, for that matter, larger expenditure on health or education or any other social sector expenditure, which directly or indirectly enhances the purchasing power of common people) as necessarily responsible for the so called 'twin deficit' followed by currency depreciation and inflation, is, in my opinion, not only farfetched but also misleading and erroneous argument.

References

Patnaik, Prabhat (2014).'Is Fiscal Profligacy the Cause of the Crisis?' Peoples' Democracy, Vol. XXXVII, No.36, September 8, 2013 available at (as seen on February 15, 2014), http://pd.cpim.org/2013/0908_pd/09082013_eco.html.

[1] For latest numbers, please have a look at http://www.vikalp.ind.in/2014/02/crossing-kautilya-rekha-of-taxation-in.html

[2] For latest figures, please have a look at http://www.vikalp.ind.in/2014/02/crossing-kautilya-rekha-of-taxation-in.html