The dangers of fiscal austerity

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It may be true that there is nothing new under the sun: it certainly feels like it when it comes to economic policy debates. The debate on the need for fiscal austerity in India is now particularly tiresome because it has been going on for the better part of three decades, spurred by governments who have declared their intention to balance budgets even when their actions have hardly suggested such an inclination. But it moves from being simply tiresome to actually dangerous when it determines policies that will actually encourage economic contraction rather than recovery while simultaneously reducing the kinds of public spending that deliver citizens their social and economic rights.

The currently dominant view in the economics profession (not just in India, but also in major developed economies) is that fiscal austerity in the midst of a slowdown is to be welcomed, because it will reduce macroeconomic imbalances and provide positive signals to private investors. It is this – along with an excessive obsession with containing government debt to GDP ratios to some supposedly acceptable levels – that is driving the attempts to cut public spending in many parts of the world even as GDP growth decelerates and unemployment increases.

This argument has a long history: nearly a century ago it was the basis of the so-called "Treasury view" in England (in the 1920s and 1930s) that Keynes so effectively demolished. Unfortunately, despite the flaws in reasoning of that approach, it did not die the natural death it deserved. Rather, it re-emerged in perhaps even greater force in the closing decades of the last century, actively aided by financial interests that have sought to reduce the active role of the state in different ways. Notwithstanding a very brief interlude of flirtation with Keynesian recovery policies just after the Great Recession of 2008, the so-called "Treasury view" is not only alive and well, but even dominates macroeconomic policy thinking in a wide range of developed and developing countries.

Globally, it is already evident that fiscal tightening in stressed economies is self-defeating. By reducing GDP growth and thereby fiscal revenues, it makes economic recovery more difficult and is counterproductive in terms of improving fiscal indicators. It is difficult if not impossible to reduce debt to GDP ratios in a period when the rate of interest on debt far exceeds the nominal growth rate.

Further, widespread acceptance of the goal of fiscal austerity (such as was evidenced in the European Union's recent agreement on budget rules) is bad news for macroeconomic rebalancing that would allow recovery in the currently deficit countries. Trade surplus countries show no willingness to reduce surpluses or enlarge fiscal deficit, and this bodes ill for global growth prospects. What will drive growth – globally and nationally – when countries persist in following austerity programmes that cut incomes and demand?

It is true that not all major capitalist countries have been following such a counterproductive strategy. In this context the contrast between the United States and the United Kingdom after 2008 is instructive. The Obama administration followed the massive financial bailouts with significant increases in the fiscal deficit. One can argue about their size, direction and scope, but even so the weight of this countercyclical spending operated to prevent further downslide and allowed some recovery of both output and employment. By contrast, the United Kingdom chose the path of austerity – largely self-imposed since it is not a member of the eurozone and did not face the same external constraints of some of the eurozone deficit countries. The UK economy is still limping along at levels of output and employment that are well below pre-crisis levels.

The tragic – and ongoing – experience of Greece confirms this analysis. The aggressive cutbacks in public spending that have been forced on the Greek government by the successive EU-IMF bailout packages worsened the macroeconomic situation, such that the economy has now been contracting for five years continuously. The rate of decline has far exceeded the most pessimistic projections of the IMF or the EU. Since tax revenues can hardly improve in this situation even with the most sweeping attempts at improved collection, fiscal balances cannot improve, even with further harsh public spending cuts. And the ratios of public debt to GDP continue to deteriorate, simply because the denominator is falling so rapidly. This in turn keeps the yields on Greek government bonds high, which makes it harder and more expensive for the Greek government to finance any planned spending. In this extreme case, the only solution must come from a combination of debt restructuring and expansionary policies, including higher public spending. Quite simply, the Greek economy has to grow out of the crisis, pushing it further into contraction can only make matters worse.

All this international experience is not just a matter of idle curiosity about the rest of the world but directly relevant for India. And it is particularly relevant today because all the signs are that the government intends to push for fiscal austerity even as the economy slows down. There is already evidence that the Finance Ministry is attempting to prevent the fiscal deficit from going much beyond his projections by clamping down on expenditure in the remainder of the current fiscal year, reducing the release of financial flows to Ministries and state governments through a variety of methods. It's not yet official, but fiscal austerity is already being introduced in practice.

Meanwhile, the economic downswing is more than just straws in the wind. GDP growth has very clearly decelerated quite sharply. It is likely to be only 5 per cent for the year from April 2012 to March 2013 if the CSO's latest projections are to be believed, and maybe slightly more if the Finance Ministry is correct in assuming some revival in the last quarter. Industrial production has been flat over the financial year so far, growing at only 0.1 per cent at an annual rate. Mining (-1.5 per cent) and capital goods production (-11 per cent) have both fallen absolutely over April-November 2012 compared to the same period in the previous year.

Agriculture is also likely to perform poorly: on current projections food grain output (estimated to be 118 million tonnes) will fall by around 6 million tonnes in 2012-13 compared to the previous year, and the poor winter rains suggest that the final harvest may be even worse.

Meanwhile inflation still remains unacceptably high, with the WPI increasing at more than 7 per cent per annum and the consumer price index still at double digit levels, hitting 11 per cent for the month of December 2012 over Dec 2011. Food inflation has recently accelerated again and is more than 9 per cent. Despite the slowdown, the trade deficit has worsened, reflecting the headwinds from global export deceleration.

Some officials claim that all this is proof that the imbalances in the economy are too high and need to be restrained by cutting down on the deficit by reducing public spending. In fact, this strategy is likely to be counterproductive, especially if – as seems likely – the fiscal cutbacks are directed towards areas with high multiplier effects, such as public service provision and "welfare" schemes. Cutting down on these is not just bad from the perspective of ensuring better conditions for the mass of people and politically stupid in a pre-election year. It is also wrong macroeconomics, because it adds further downward pressure on an economy that is already slowing down.

In any case, in the presence of unutilised capacity and unemployment, more spending does not have to generate higher deficits as the increased incomes will also cause government revenues to rise. In the case of sectors with apparent supply constraints, such as agriculture, spending designed to reduce these bottlenecks can have positive results from both supply and demand sides.

The idea that it is necessary to cut the fiscal deficit because of the need to control inflation is also wrong in the current situation, because much of the inflation – particularly in food items – is of the cost-push variety. But many of the government's moves have been such as to increase these cost-push factors. The diesel price hike is an important case in point that exposes the contradictory nature of this strategy. The government says that it wants to meet fiscal targets in order to fight high inflation that is eating into the real incomes of workers and salaried persons. Yet it attempts to do this by cutting subsidies on energy and food, which lead directly to higher prices and also indirectly contribute to more inflation because fuel enters into all other prices. This policy obviously cannot succeed and will only intensify the inflationary pressure. In the worst case scenario we can end up with stagflation – decelerating growth and relatively high inflation.

Of course it may be naïve to believe that all this is happening simply because the Indian government (along with some others) has been persuaded by a wrong economic theory. It may well be that this really reflects the continuing political power of financial lobbies and those who wish for cutbacks in public spending so that there is more freedom for private profit-oriented activity in these areas. But even such interests are mistaken if they think that private corporate activity can flourish in such a context of wider economic decline.