What could be wrong with a Fiscal Deficit*

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I have written about this in the past, but since bad economics comes thick and fast from the representatives of finance capital, especially the Bretton Woods institutions located in Washington DC, there is no harm in my repeating myself.

The issue relates to a fiscal deficit and has acquired urgency at present because revenues of governments everywhere in the world, including India, have declined owing to the pandemic-induced lockdown, while the need for government spending on relief and healthcare has escalated steeply, necessitating larger fiscal deficits.

Two grossly erroneous propositions are advanced in this context by the representatives of finance: one, that a fiscal deficit beyond a certain limit (usually 3 per cent of GDP) must always be avoided as it either tends to be inflationary (if it is monetized, i.e. if the additional government borrowing it causes comes from the Central Bank), or crowds out private investment (if the additional government borrowing comes from the private sector). Throughout this discussion I shall ignore for simplicity the case of borrowing from abroad.

The second erroneous proposition is that if, instead of borrowing, the government finances its expenditure by selling some asset of its own, like public sector equity or government land, then there will be no ill-effects like those of a fiscal deficit; in fact the sale proceeds from these assets are shown as government income, on a par with its tax revenue, and hence the enlarged fiscal deficit disappears. Let us examine these two propositions seriatim to see why they are wrong.

In an economy where there is unutilized capacity and unemployment, i.e. an economy which is demand-constrained, a fiscal deficit, even if financed by government borrowing from the Central Bank cannot possibly be inflationary. Inflation occurs if supply cannot increase while demand increases, at base prices; but in an economy which is demand-constrained an increase in demand will cause an increase in output and hence supply, and not in prices. Hence there is no question of its being inflationary in a situation like the present one, where both unutilized capacity and unemployment exist.

The only difference that borrowing from the Central Bank, as opposed to borrowing from the private sector makes, is the following: if the government borrows from the Central Bank which prints money and gives it to the government, then the government's spending puts this money into private hands; if the government borrowed instead from the private sector then that would put government bonds into private hands. If money is put into private hands then they hold claims upon the Central Bank which in turn holds claims upon the government (against which that money was printed): hence the private sector holds claims upon the government indirectly. But if the government borrows directly from the private sector then it holds claims upon the government directly. That is all the difference there is between the two situations.

We have been talking about the "private sector", but since workers more or less consume what they earn, it is the capitalists whose savings increase because of the

fiscal deficit and who hold claims upon the government. And here the real point to note is the following. The claims that capitalists hold against the government because of the fiscal deficit have been put into their hands by the fiscal deficit itself. It is a booty handed to them by the government which they have done nothing to earn. The resources which the government obtains for spending through a fiscal deficit come out of the larger output generated by the stimulus it provides, and the profit part of this output simply lands on the capitalists' lap, a fraction of which they hold as savings, in the form of claims on the government.

This also tells us why a fiscal deficit is not a good way of financing government spending. It is not because of the spurious arguments put forward by the representatives of finance, but because a fiscal deficit increases wealth inequality. If for instance the government taxed away this booty through a profit tax or a wealth tax, then the capitalists' wealth will remain the same as it was before the increase in government spending; but if it does not, then this wealth increases by exactly the amount of the fiscal deficit. This increases wealth inequality in the country.

Since a fiscal deficit puts wealth into the hands of the capitalists without their doing anything to earn it, it gratuitously increases wealth inequality in the economy; and that is what is wrong with it, compared for instance to tax-financed government spending.

As regards financing government spending through sale of government assets, however, the IMF does not count it as part of fiscal deficit, which is absurd for the following reason. We have seen that a fiscal deficit puts (in a closed economy) an exactly equivalent amount of claims on the government in capitalists' hands. These claims may be held indirectly, when capitalists hold money, or directly, when they hold government debt. Sale to them of government assets, like public sector equity or government land, only changes the form of their claim on the government.

If public sector equity is sold, then such equity only replaces money in capitalists' hands (if the deficit is financed by borrowing from the Central Bank); likewise it only replaces government bonds when the deficit is not monetized. Hence the effect of selling government assets is absolutely no different from that of the conventional fiscal deficit; in fact government spending financed by the sale of government assets should be counted as fiscal deficit, exactly on a par with spending financed by the sale of government bonds.

But then why does the IMF think otherwise? The reason is entirely ideological. While there cannot possibly be any difference between two situations, one where the government finances its spending by putting claims upon itself in the form of government bonds in capitalists' hands, and the other where the government spends by putting its equities in capitalists' hands, the reason why the IMF counts the first as fiscal deficit and frowns upon it, while allowing the second, is because it wants the public sector to be privatized. It is this ideological preference that makes the IMF pretend that sale of public sector equity should not be counted as fiscal deficit.

The same can be said of government sale of land. While its economic consequences are exactly the same as government sale of bonds (which is what a fiscal deficit entails), it is not counted as fiscal deficit, as it should be. It is patently erroneous in

short to treat the sale of government land as a revenue-raising measure. Yet many economists, influenced by the IMF's thinking, do so.

This has an unfortunate consequence. Whether the government spends by selling bonds or by selling land also makes no difference to the fact that it increases wealth inequality. A fiscal deficit increases capitalists' wealth by putting government bonds (or money) in their hands over and above the wealth they had before the government decided to spend more by resorting to a fiscal deficit. Putting land or public sector equity into capitalists' hands makes not an iota of difference to this fact; it only changes the form of their wealth, not the fact of capitalists getting additional wealth and hence there being an increase in wealth inequality in society.

While an increase in government spending in India in the current circumstances is a must, given that the Indian economy is demand-constrained, advocating that this spending should be financed through a sale of government land displays a lack of awareness, both of the fact that selling land is no different from a fiscal deficit, and that it also entails an increase in wealth inequality.

If the economy is to be stimulated and if wealth inequality is to be prevented from becoming worse than the horrendous level it has already attained, then the only way this can be done is by larger government spending that is financed by a tax on the rich, either a profit tax or a wealth tax.

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