Fiscal Folly*

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The Modi government has been raising taxes on petro-products as its main instrument of resource mobilisation for government spending. This ironically has the dual effect of not stimulating the economy, but stimulating inflation instead. An alternative fiscal policy of raising resources through direct taxes on the rich (of which wealth taxation is the best possible option) and using those proceeds to increase government expenditure would have both stimulated the economy and kept down the rate of inflation.

To see why this is the case, consider the following simple example. Suppose the government wants to spend an additional Rs 100 and raises the amount by raising taxes on petro-products. This raises petrol and diesel prices and has a cost-push effect across the board by raising transport costs; in addition it also raises the cooking gas price which has a direct effect on the cost of living. The impact of a rise in petro-product prices falls much more heavily on the working people for this reason, than on the well-to-do. But the working people consume the bulk of their incomes anyway; if their real income goes down, then there is a corresponding fall in their real consumption. Hence Rs 100 raised through taxes on petro-products reduces consumption demand by close to Rs 100, even as the spending of this amount by the government increases aggregate demand by Rs 100. The net increase in aggregate demand therefore is very little, which is why this entire fiscal policy fails to stimulate the economy.

At the same time however there is a rise in prices owing to this fiscal policy, which after all is why the working people's consumption goes down. We thus have the dual deleterious effects mentioned earlier: there is hardly any stimulation of the economy even as the rate of inflation increases. This is exactly what has been happening in the Indian economy. The rate of inflation has been increasing (it has reached 4.48 per cent in October 2021 compared to October 2020), but industrial stagnation persists, together with huge foodgrain stocks with the Food Corporation of India. The Index of Industrial Production was just 3.1 per cent higher in September 2021 compared to a year earlier; it was 2.6 per cent lower compared to the previous month, that is, August 2021.

The fiscal policy being pursued by the Modi government therefore squeezes the per capita real income of the working people through inflation, and at the same time does not increase employment. It is precisely the kind of policy a government should not pursue in a situation where there is so much "slack" in the economy in the form of unutilised industrial capacity and foodgrain stocks; in such a situation, which corresponds to what economists call a "non-zero-sum game" (that is, a situation where one's benefit need not be at the expense of another), the working people can be made better off through the creation of larger employment, without even impinging on the capitalists' profits and wealth, while the government of the ruling classes still manages to spend more on infrastructure. But instead of using the "slack" that exists in the economy for spending more on infrastructure, the Modi government is squeezing the working people to spend more on infrastructure (even this spending is being cut down now), while leaving the "slack" in the economy untouched.

Now consider an alternative policy. Suppose the government lowers the taxes on petro-products and does the same amount of spending that it was doing in the above case by enlarging the fiscal deficit; then there will clearly be an expansion of aggregate demand, since the increase in demand caused by the increase in government expenditure (by Rs 100 in our example) will not be offset by any decrease elsewhere, since there is no taxation of anybody for mobilising resources in this case. This will raise the level of activity and employment in the economy, while bringing down inflation. From both points of view, inflation control and employment creation, this would be a better option: the working people will gain both from lower inflation and from higher employment.

The problem with a fiscal-deficit-financed increase in government spending however lies elsewhere: it causes a gratuitous increase in wealth inequality. A fiscal deficit entails borrowing from the domestic private sector (we are leaving aside for simplicity all borrowing from abroad), which basically means from the domestic rich, namely capitalists and their hangers-on. But the Rs 100 (in this case) that the government would be borrowing from these domestic rich is put into their hands by the government's spending itself via raising the level of economic activity. They do not save this amount by lowering their consumption compared to what it was in the base scenario before this entire operation of increasing government spending by Rs 100 began. These Rs 100 of savings in their hands are generated by this operation itself, and these savings come to their hands even as they increase their consumption compared to the base scenario. Government spending financed by a fiscal deficit therefore gives the domestic rich a bonanza: they can increase both their consumption and their wealth (since savings represent an addition to wealth) without doing any sacrifice whatsoever. It is just a gift handed to them which is not at the expense of the workers but which arises because of the existence of the "slack" in the economy.

This is where direct taxes come in. If there is an increase in direct taxes on the domestic rich by Rs 100, then the government budget remains balanced, with Rs 100 of its additional spending being matched by Rs 100 of additional revenue; there is therefore no question of borrowing anything from the domestic rich, no question of their savings increasing by Rs 100, and (since their savings are a certain given proportion of their income) no question of any increase in their income and hence in their consumption either.

Of the various direct taxes the best by far is wealth taxation, for it directly attacks the increase in private wealth that would otherwise have come into the hands of the domestic rich following an increase in government spending. An increase in direct tax revenue at the expense of the rich increases employment, keeps down inflation, and does not gratuitously increase private wealth; an increase in wealth tax revenue has the added advantage that it hits the target directly. It is not as if the existing wealth of the domestic rich is diminished in any way; a wealth-tax-financed increase in government expenditure just prevents any further gratuitous accretion to their wealth. This mode of financing government spending therefore is superior both to what the Modi government is doing (which is to raise indirect taxes, in the form of taxes on petro-products), and to an increase in the fiscal deficit.

But then why is the government not resorting to this measure, and is instead pursuing a path of fiscal folly which attacks the working people both by keeping up unemployment and by increasing inflation that lowers their per capita real incomes?

The answer lies in the demands of globalised finance capital, and in the prescriptions of institutions like the IMF that act as the conduits for these demands. Globalised finance capital is opposed to wealth taxation, for that hits the domestic corporate-financial oligarchy aligned to it; and the Modi government whole-heartedly supports such softness towards this oligarchy. Globalised finance is also opposed to an increase in the fiscal deficit, which is why we have a legislation like the FRBM Act that puts a ceiling on fiscal deficit as a percentage of the Gross Domestic Product. What is left therefore is indirect taxation, and the easy way discovered by the Modi government for raising indirect tax revenue is by taxing petro-products. The fiscal folly of the Modi government therefore is completely in sync with the demands of globalised finance capital.

But, with oil prices rising in the international market, a pursuit of such a fiscal policy will only increase further the rate of inflation domestically. And if the government wants to control inflation then it will not raise domestic petro-product prices in line with world prices, but instead cut back somewhat the taxes on such products (as it has done recently); but then it will balance such cuts with a lowering of government expenditure to keep the fiscal deficit within bounds so that globalised finance capital remains happy. Ironically therefore the government will be trying to control inflation by worsening unemployment, even in a situation of considerable "slack" in the economy.

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