Reviving the Economy through Incantations*

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Voltaire had said "one can always kill a man with incantations, plus a little poison". Voltaire was a rationalist which the BJP government alas is not. It believes that one can revive an economy with incantations alone, for that is what the budget for 2021-22, presented a few days ago by the Finance Minister promises to do to the Indian economy.

The Indian economy is supposed to have shrunk by 7.7 per cent during the fiscal year 2020-21 compared to the previous year, and it is supposed to rise by 10.5 per cent during 2021-22 compared to 2020-21 according to the Reserve Bank of India. (The Economic Survey gives a slightly higher figure of 11 per cent for the growth-rate of GDP for 2021-22 but this difference is of little consequence; and the argument below will hold with even greater effect for a projected 11 per cent growth).

This means that the Gross Domestic Product in 2021-22 would be just about the same as in 2019-20 in real terms (in fact a marginal 2 per cent higher). This is the basis on which government spokesmen have been talking about a V-shaped recovery; in other words, the recovery from the trough would bring the economy more or less to the same level where it was before falling into the trough.

But let us look at the components of expenditure that are supposed bring GDP back to the old level, that is, to cause a 10.5 per cent increase from the bottom of the trough. The GDP of any country necessarily equals consumption (C) plus investment (I) plus government expenditure (G) plus net exports (X-M). And if the GDP is to rise by over 10 percent from the trough, then these items together must rise by that much over their combined level in 2020-21 in real terms.

Now, nobody can say anything about how net exports will behave next year; and the government's claim about a V-shaped recovery is surely not based on any extravagant assumption about the growth of net exports. Let us therefore keep net exports out of the picture and see if the policy measures announced in the budget are such as to bring about an increase in C+I+G in real terms by about 10 per cent compared to the trough.

Now the government's total expenditure is supposed to increase from Rs.34.503 lakh crores in the year 2020-21 (RE) to Rs.34.832 lakh crores in 2021-22, i.e. by less than 1 per cent in nominal terms, which means it is supposed to decline in real terms. Of course the composition of government expenditure in the coming year will be different from what it was in the year of the pandemic, but in basic macroeconomic terms the thrust to the economy from this source of demand, viz. government expenditure, will, if anything, decline compared to the pandemic year.

Consumption can normally increase at best at the same rate as the GDP. In the coming year, there are reasons to expect that even this may not happen, and that the growth of consumption will be lower than that of the GDP. This is because many working people have had to borrow during the pandemic to maintain their consumption, when they were suddenly cut off from their income sources because of the abrupt shutdown; and now they have to repay their debts by skimping on consumption even as their incomes rise. The percentage increase in consumption with a 1 percent increase in GDP is likely therefore to be less than one, which means that if the GDP increases by 10.5 percent in real terms as visualized, then consumption at the macro-level will increase by less than 10.5 per cent.

That leaves private investment and that segment of public investment which does not figure in the budget, such as investment by public sector enterprises. During the pandemic year, the shutdown had meant that on a number of projects work had to be suddenly interrupted, because of which when the shutdown was eased, there was a flurry of investment expenditure to quickly finish the projects in the pipeline. The investment expenditure undertaken in the fiscal year 2021-22 will be determined significantly (that is, leaving aside residual expenditure on projects in the pipeline) by investment decisions taken during the last year. But last year was a pandemic year, when output was contracting; besides, looking ahead from the pandemic year, output in the subsequent year, i.e. 2021-22, was expected at best to come up to the pre-pandemic level; and the capacity for producing that output already existed in the economy. The decision to undertake new investment therefore must have contracted significantly in 2020-21. It follows that the ratio of investment to income for 2021-22 must be lower than in 2020-21.

It follows that each of the components of GDP, leaving aside net exports about which we know very little, will rise by less than 10.5 per cent if the GDP in the economy rises by 10.5 per cent. This means that if the GDP does actually grow by 10.5 per cent, then (barring the fortuitous circumstance of a massive boom in the world economy that would boost our net exports) there would not be enough demand in the economy to absorb this larger output. This in turn means that the larger output simply will not be produced.

And since any decline in output below what has been supposed to obtain, will mean lower consumption (than what would have occurred if the supposed growth rate had prevailed), the initial decline in growth rate will have a multiplier effect.

There is thus little reason to believe that anything like a V-shaped recovery will occur in the Indian economy. The budget simply does not allow for such a recovery because it provides for no real increase in government expenditure. At the very least, to have a 10.5 per cent growth from the trough, government expenditure should have increased by 10.5 per cent in real terms. But the Finance Minister’s budget does not provide for that; on the contrary it provides for a real contraction in total central government expenditure.

There is a further point here. The reduction in the percentage of the fiscal deficit to GDP from 9.5 percent in 2020-21 to 6.8 percent in 2021-22, is because while the nominal government expenditure is supposed to remain unchanged, the increase in real GDP by 10.5 percent is expected to increase tax revenue. But if the growth in GDP is less than supposed in the budget, then, even assuming that the budgeted expenditure target is met, the size of the fiscal deficit will be much larger than budgeted; and if the government in response cuts back on its expenditure, then the GDP growth rate will be even lower.

It follows that this budget is not a means of effecting a recovery in the Indian economy. The significance of this lies in the fact that the unemployment crisis that has afflicted the Indian economy over the last several years, and especially during the pandemic year, will continue to remain severe. Even if the economy could have recovered as the budget visualizes, there would still have been a severe unemployment problem, because the distribution of this growth across sectors would have been against the petty production sector that has been particularly badly hit by the pandemic and the associated shutdown. Ever since the entirely pointless demonetization carried out by the Modi government the petty production sector has been in decline and the shutdown only aggravated this decline, making it a poor candidate for benefiting from a recovery; and since employment per unit of output is much larger in this sector than elsewhere, the problem of severe unemployment would have persisted. But with the recovery itself being stunted, the problem would be quite acute.

This is such a conservative budget, indeed the very opposite of what was needed, that it is surprising to find so many see in it an attempt to revive the economy. Perhaps in the miasma of words and flash of rhetoric that invariably characterize the budget speech on such occasions, the simple macroeconomic picture tends to get lost.

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