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Fiscal Stimulus for an Ailing Economy

What is the issue?

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- India's GDP growth in the April-July quarter slumped to 5.7%.

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- Demands for unleashing a fiscal stimulus have grown stronger.

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What is it?

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- A 'stimulus' is an attempt by policymakers to kickstart a sluggish economy through a package of measures.

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- A monetary stimulus will see the central bank expanding money supply or reducing interest rates to encourage consumer spending.

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- A fiscal stimulus is one in which the government spends more from its own pocket or slashes tax rates.

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- Stimuli puts more money in the hands of consumers and spending goes up - thereby encouraging demand & growth.

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What is the logic behind?

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- **Concept** - Proponents of fiscal stimulus, base their arguments on the Keynesian theory of macro economics.

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- Keynes argued that even small direct interventions by the Government to prop up demand, can have a disproportionately high impact on economic growth due to the multiplier effect.

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- **The explanation** - When demand in an economy stays weak for long, businesses stop investing in new projects, unemployment rises, income shrinks and consumer confidence wanes.

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- This further hinders spending due to lack of money and thereby dampens demand - creating a vicious cycle.

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- If the Government can step in with a fiscal stimulus, it revives business confidence, restarts projects, creates jobs and sets off a virtuous cycle of feel-good, demand and growth.

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What was our previous experience?

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- The 2008 Sub-prime crisis saw countries like US, Europe, Japan and China rolling out large fiscal stimulus packages.

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- India's too gave out a package then included export subsidies, excise duty cuts and Rs.10,000 crores for infrastructure financing.

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- The government employees were also given a pay revision & a large order for new buses to replace public transport fleets was made.

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- As a consequence GDP growth revived from 6.7% in FY09 to 8.6% in FY10 and to 8.9% in FY11.

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- But at the same time, fiscal deficit of the government for FY09 rose to nearly 8% of GDP, from the projected 2.5%.

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- Subsequently, when the stimulus was rolled back, growth promptly slumped.

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What are the concerns now?

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- The government currently faces a situation very much similar to the one in 2008.
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- While generous public spending may boost investments & demand, the government will loose out on its fiscal deficit target that is currently pegged at 3.2 %.
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- This may not go down well with foreign investor sentiments.
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- Whether the economy will take off on its own once the stimulus wears off is also doubtful.
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How does the future look?

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- If the government decides to go with the stimulus it would have to identify its priorities clearly.
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- Duty cuts on petrol, constructing of affordable homes, banks recapitalisation & cheaper lending to MSMEs are some options.
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- While a stimulus will rejuvenate the economy through budgetary spending, the government would have to eventually earn it back.
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- Hence, tax revenues through other means will ultimately pinch the citizens after a while.
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Source: Business Line

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