Building back differently

It is clear that the government has not, to date, been able to present an analytical framework to address the exacerbation of the structural downturn in economic growth caused by Covid. Inappropriate legacy analytics have hobbled the government’s ability to mount an effective response to the situation.

The language and grammar of most macroeconomic policy in India is based on business cycle theory. Simply put, there is a trend growth rate with ups and downs — variations around the trend. This is captured by empirically constructing a polynomial that is stochastically robust to econometric testing. Policy seeks to be “counter-cyclical”. Alternatively, “output-gap” analytics is deployed — posit a potential output for the Indian economy and then observe whether actual output is close to, or further from, this potential output. This output gap is then used to recommend whether fiscal and monetary policy should encourage or dampen economic activity to secure macroeconomic stabilisation.

But when there are shocks to trend, like Covid, output gap- and business cycle-based analytics are not helpful in addressing the fallout. Fiscal and monetary policy must counter shocks to aggregate supply and demand to reverse a lower trend growth rate. But in the face of an unprecedented decline in gross domestic product, policymakers have used legacy analytics to reject calls to boost aggregate demand through income support. The larger deficits for FY21 and FY22 are simply because, with a negative trend shock, the negative correlation between fiscal deficits and real output growth runs from the latter to the former.

On micro-foundations, the orthodoxy is that macroeconomic analytics must be consistent with the laws of demand and supply, and market price signals. But in the real world, it is important to be clear about (1) whether these actually demonstrate the working of the laws of demand and supply. For example, in the Indian context, an increase in petroleum prices should result in a fall in demand for petroleum. This does not happen. To then argue for lower petroleum taxation would be to proceed on erroneous micro-foundations, and damaging to the macro-economy.

(2) Whose micro-foundations we are talking about? One example — the literature on minimum wage hikes shows that these actually increase economic activity — a fact that refutes what standard macroeconomic models conclude.

This take on the role of micro-foundations in policymaking is important in the Indian context. When it is clear that inequality is becoming an impediment to economic growth, then it is important to unpack the components of aggregate demand. If this unpacking indicates that relative prices have moved heavily in favour of discretionary spending by the top 10 per cent, then it is important to consider whether economic policy should actively intervene to alter it, instead of just compensating losers with handouts. Not doing so results in a profit-led recovery, as we have witnessed, which further exacerbates the structural demand problem.

The profit-led recovery from Covid has illuminated in footnotes what I have been arguing for some time — that the composition of growth directly impacts macroeconomic performance through inequality.

There is a well-established macroeconomic premise that in fully developed economies, the rate of return on capital (r) tends to be higher than the rate of growth of income (g). When r > g, wealth accumulated in the past yields more income than that earned in the present, generating inequality. Redistribution fiscal policy corrects this by taxing the incomes and assets of those who earn incomes from r and providing subsidies and merit goods to those earning incomes from “g”.

This relationship holds when labour and capital resources are fully employed (the “steady state”). Only changes in productivity and technology can change the values of r and g. But emerging and developing economies like India are, by definition, not at steady state. They are “catching up” with developed economies, and as long as they are doing so, the opposite relation should hold: r < g.

It is a matter of great concern if inequality rises when r > g, as was the situation before the Covid blow to the economy. This is not so just for normative reasons; if a rising tide lifts all boats, then the prosperity of all will increase, and that is a good thing, even if some become more prosperous than others. However, this is not automatically so. Compare Brazil with Japan. In Brazil, unlike Japan, a steady state has been reached but inequality keeps a large number of people in relative poverty and extreme vulnerability. Growth provides no panacea for this as r is now equal to, or greater than, g.

The Covid crisis has temporarily created a situation where r > g. As a consequence, the profit-led recovery has further exacerbated inequality. But just going back to business as usual will not solve for this. We will be back in a situation where r > g but with higher levels of inequality. The prospect of economic stagnation looms larger, and closer, unless we change tack to build back differently.

It is, therefore, essential that in building back from the Covid shock, the r > g dividend is used to alter the output composition of demand, recognising that the pattern of growth, and the resultant output composition of demand, has been inherently unequalising. This has scarred the economy in many ways, and is at the root of the structural fiscal weakness of the government, the squabble over meagre resources to fund essential public goods, and the need to constantly deliver handouts and cash transfers to protect people from immiseration, as they do not share in the prosperity that growth brings.

The writer is managing director, ODI, London. r.roy@odi.org.
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