A False Theory*

Prabhat Patnaik

First it was the Finance Secretary who said that if the government borrowed less then more savings would be available for the private sector to borrow. Then it was the Deputy Governor of the Reserve Bank of India who talked of government borrowing "crowding out" private borrowing. The common theme here is that there is a given amount of savings, a fixed pool as it were, from which if the government takes more, then less will be available for the private sector.

This is an erroneous theory whose falsity was established almost ninety years ago in 1931 by a Keynesian economist called Richard Kahn, and formed the basis of the theoretical revolution in orthodox economics ushered in by John Maynard Keynes. Keynes himself was a bourgeois economist concerned with preserving capitalism against the socialist challenge; but precisely for that reason he recognized what he considered the fatal flaw of capitalism, that it was afflicted with intolerable levels of unemployment, and advocated State intervention to mitigate unemployment.

This did not work out in practice; capitalism proved to be incorrigible. But Keynesian insights into the system, also independently arrived at contemporaneously by the Polish Marxist economist Michal Kalecki and already anticipated in a large measure by Marx three quarters of a century earlier, remain valuable, which is why it is amazing to see two senior functionaries of the government of India putting forward theoretical positions which were discredited ninety years ago.

The falsity of the theory of a fixed pool of savings arises for the following reason. Savings in an economy evidently depend also upon the level of its income; to say that there is a fixed pool of savings presumes therefore that the level of income is given, which means that the economy must be at full employment. (The theory is false even if the economy is at full employment, but let that pass for the present). But if the economy is not at full employment (or full capacity production), then larger government spending increases demand, and hence employment and output, and hence savings itself.

If we assume a closed economy for simplicity, then government expenditure, financed by borrowing, in fact generates an exactly equal amount of additional private savings, over and above the savings that were being generated before this expenditure was undertaken; and the extra income it generates is exactly such as would produce just this much of additional private savings.

If for instance the government spends Rs.100 and borrows the entire amount, in an economy where wage and profit shares are exactly half and half, and where workers do not save while capitalists save half of their profits, then the increase in income because of government expenditure will be exactly Rs.400. Out of this Rs.400, the entire wage-bill of Rs.200 and half the profits, i.e. Rs.100, which means a total of Rs.300 will be consumed and the remaining Rs.100 will be saved. Government expenditure financed by borrowing in other words puts into the capitalists' hands, without the capitalists having to do anything about it, the very resources that the government borrows, and that too to an exactly equal amount. So the question of crowding out simply does not arise. Government expenditure, financed by borrowing, creates at any given interest rate an excess of private savings over private investment exactly equal to itself in a closed economy. (In an open economy it is the sum of the surplus of the private sector and of the rest of the world, i.e. the current account deficit on the balance of payments, together, that must equal the fiscal deficit).

Of course when the government floats bonds there may be some immediate impact on the salability of private bonds, but this soon disappears, so that taking the period as a whole government borrowing does not reduce private investment, but generates additional private savings in excess of private investment exactly equal to itself. Just as two persons entering a door simultaneously may create a temporary nitch, from which we cannot infer that the room to which they are both entering is jam-packed, likewise from the immediate impact of government borrowing we cannot infer "crowding out". On the contrary, the effect of government borrowing over any period is exactly as discussed above.

But then why are government functionaries saying what they are? True, it shows a complete innocence of economics on their part, but how did they come to say what they did? To see why they did we have to distinguish between two very different criticisms of a fiscal deficit.

One which is from the Left says, quite rightly, that a fiscal deficit does not lead to any "crowding out" or to any inflation (in an economy with unutilized resources), but on the contrary increases demand and hence output and employment; but the Left opposes a fiscal deficit because it gratuitously increases capitalists' wealth for nothing that they have done. In the above example the government's spending of Rs.100, while it raises output and employment, increases capitalists' wealth by Rs.100 which they hold in the form of government bonds, i.e. claims upon the government. If the government did not resort to a fiscal deficit, but instead taxed this additional wealth, which in Keynes' own words is a "booty" landing in the lap of the capitalists, by imposing a wealth tax of Rs.100, then nothing else will change: the additional output generated by government spending will still be Rs.400; the increase in employment will be exactly the same as before, the increase in the wage-bill will be exactly the same as before; but there will be no extra wealth for the capitalists, no "booty" landing in their lap.

The argument of finance capital however is that a fiscal deficit will lead to "crowding" out private investment. This, as we have seen, is a false argument, which Joan Robinson, another Keynesian economist, had called the "humbug of finance". But then why does finance capital advance this argument even after ninety years of its being clearly disproved, and which our senior government functionaries are merely echoing. The reason is that finance capital is opposed to State intervention to raise employment directly through its own expenditure; it would much rather have the State providing all kinds of incentives to capitalists to induce them to invest or spend more. The State must not take over the capitalists' role, for then tomorrow the people may ask: if we have to have the State to intervene for increasing employment, then why do we need capitalists at all?

It is this fear which haunts the capitalists, so that even though they too benefit from State intervention for raising the level of activity (in the above example, profits too have gone up by Rs.200), they nonetheless oppose State expenditure undertaken for this purpose. They do so even if this State expenditure is financed not by any taxes upon them but by a fiscal deficit. Finance capital’s argument in other words is an analytically false, but a self-serving, argument.

The Deputy Governor of the Reserve Bank of India went even a step further in his reported remarks. While he thought that government borrowing crowded out private investment, he wanted the government to finance its expenditure by disinvesting equity in public sector enterprises.

Now, let us for a moment assume that government borrowing does crowd out private investment because there is a fixed pool of savings, i.e. let us assume that the false argument is actually true. Even so, it is absurd to claim that selling government bonds crowds out private investment but selling government shares (in public sector enterprises) does not. If the one leads to crowding out, then so must the other. The argument being advanced in short is a purely ideological one, which has no analytical validity even at the level at which it is being advanced. And this is so even if we assume that the crowding out argument is a valid one.

The hegemony of finance capital is exercised inter alia by its pushing a whole array of false theories. The falsity of these theories needs continuously to be exposed.

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