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DEFICIT FINANCING FOR ECONOMIC DEVELOPMENT OF INDIA

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ABSTRACT

In the developing countries, financial resources are inadequate to support economic development, since per capita income is low so the rate of savings is also very low. Therefore, the government cannot increase the taxes above certain limit. The government adopts deficit financing to accelerate the process of economic development. In India application of deficit financing enables the government to obtain necessary resources for different development plans. The paper discusses how deficit financing can be used to boost up the economy by allowing the state to undertake activities which otherwise would be beyond its financial capacity. India resorted to deficit financing right from early years of planned economic development. The paper tries to analyze the impact of deficit financing on the planned economic development of India as step towards economic progress.

Keywords: Deficit financing, Budgetary deficit, Fiscal deficit

Introduction

The role of economic planning is to help in the development of any country. The economic planning of any country is dependent on the availability of financial resources of that country. Otherwise, successful planning is only confined on papers. It is easy for any economy to plan the goals and objectives for a nation but difficult to collect finances for planned projects of a country.

Today’s democratic age, socialistic view has a deep impact leading to increase in various types of public work programmes being taken up by the government resulting in day to day increase in government expenditure as compared to its revenue receipts. Deficit Financing is a necessary evil in welfare state as the state often fails to generate tax revenue that is insufficient to take care of the expenses of the state.

The concept of deficit financing gained importance at the time of the great depression period when John Maynard Keynes gave the concept as a fiscal instrument in the economic world. The idea of deficit financing is not very old. In the beginning, the classical economists supported the concept of balanced budget for economic stability. The classical economists believed that any meaningless interference in the economy of a country can be very hazardous, so the economy should be let free. Adam Smith believed that deficit financing results in allocation of resources from industry to government that will cause use of additional public borrowing for the use of unproductive works that will lower the productive capacity of any economy. Likewise, David Ricardo also believes that national debt is not only hazardous for a nation but also depreciates the original capital of a country. He also pinpointed the idea that when a country is trapped in the cobweb of debt it can neither take economic advantage nor can it increase its taxable capacity.

But the concept of classical economists proved wrong in 1930's at the time of the great depression after which the idea of unbalanced budget given by John Maynard Keynes evolved. The United States and the other developed countries used deficit financing method as a recovery measure at the time of economic crises. Today, both developed and underdeveloped countries use deficit financing given by John Maynard Keynes for economic development.

Concept of Deficit Financing

The difference between expenditure and its receipts is referred to as deficit. In context of public finance, when government spends more than what it is earning, it is called budget deficit. When the government proposes a deficit budget it is well aware of the fact that the total expenditure will be more then its receipts and so it adopts various policies and programmes that can sustain the deficit budget. This process of supporting the budget deficit by either printing of currency or through borrowing is known as deficit financing.

In the Western countries deficit financing is referred to excess of expenditure over revenue receipts financed through public loans and the creation of new money. In other words, deficit financing takes place even when a budget gap is covered by loans.

In India, the term deficit financing has been referred in a different manner. According to the Indian Planning Commission in the first five year plan, "The term deficit financing is used to denote the direct addition to gross national expenditure through budget deficits, whether the deficits are on revenue or on capital account. The essence of such a policy, therefore depends on government spending in excess of the revenue it receives in shape of taxes, earning of state enterprises, loans from the public, deposits and funds and other miscellaneous sources. The government may cover the deficit either by running down its accumulated balances or by borrowing from the banking system (mainly from the central bank of the country and thus creating money).” **(**First Five Year Plan, 1951)

The Sukhamoy Chakravarty Committee on “the working of the Monetary System in India” pointed out that the traditional concept of deficit financing was restrictive and it could just indicate the extent of monetary deficit. From 1st April, 1997, the Government of India gave up the new concept of deficit financing known as fiscal deficit.

Rationale for Deficit Financing

The economic development of underdeveloped countries is a complicated process because although the countries have their natural resources but due to problems like market imperfections and mobility of factors, education, low level of technology, capital deficiency, etc the economic development is a major problem. “Deficiency of real resources and low productivity constitute the basis for the saying that a country is poor because it is poor.” (Meier and Baldwin, 1957)

It is generally considered that there can be a few differences in the obstacles of development of the underdeveloped countries but the fact that these counties are trapped in the vicious circle of poverty cannot be ignored. “On both sides of the problem of capital formation in poor countries a vicious circle exists.” (Nurkse, 1957)

According to Ragnor Nurkse, the underdeveloped nations experience the vicious circle of poverty on both sides of demand and supply. The reason of low income causes low consumption leading to low productivity is visible on the demand side while on the other hand, the supply side is affected by low income resulting in low savings causing low investment leading to low productivity. In the case of underdeveloped countries one can see a big gap between the rich and the poor class which is also a major reason for its under development. The poor class that has low income and hence little savings are not able to play any reasonable role in increasing the productivity. On the other hand, “the savings of the rich class tend to be put into real estate, gold, jewellery, commodity hoards and hoards of foreign and domestic currency.” (Nurkse, 1957). In underdeveloped countries it is often seen that the savings of the rich is mostly invested in unproductive works, the reason why the vicious circle remains unbroken and therefore these countries face major problem in private investment.

In order to break free the vicious circle, a huge amount of investment is required. If the economy of the under developed nations uses investment through deficit financing, it will result in increase in the national income that is much more in comparison to the increase that comes from the multiplier effect of investment.

How Deficit Financing can boost up the Economy?

Deficit Financing is a necessary evil in welfare states that is used in different countries for different purposes. In a developing country like India deficit financing is mainly used to give speed to the idle resources of the country. India being a developing nation uses deficit financing for the maximum utilization of its unutilized resources. Agricultural sector is considered as the main sector in any developing country where maximum population works and does not need any specialized technological knowledge, equipment and machinery. Since agriculture sector engages a large part of labour, unemployment is not visible. In the industrial sector also the productive capacity does not seem useless whereas the reality is that the contributions of such works in these sectors is almost nil and somewhere even negative. To boost up the idle resources of any nation deficit financing can be utilized but the danger of inflation continues to arise if the output does not increase immediately. But this situation does not support the idea of not using deficit financing but on the contrary "underdeveloped economies should be encouraged to develop their productive resources as rapidly as possible without the fear of inflation." (Kurihara)

When deficit financing is applied on any economy the supply of money increases thereby increasing the purchasing power and hence the prices begin to rise. Since price and consumption has opposite relation so as the prices increase, consumption starts decreasing and people are forced to save rather than spend. The forced savings of the people is invested in the form of interest bearing certificates that causes resources to shift from personal consumption to the government. The government uses the resources in productive works thus generating employment and increasing the income. But the usefulness of forced savings depends on the fact that the increase in prices should not result in increase in wages, the forced saving should not have adverse effect on the savings of fixed income class and the number of wage earner class in an economy should be high.

The increase in the national income of a country is very important for the development of the nation because increase in the national income will increase the savings and investment as well. But this is not a generalized concept because the savings behaviour of the people of any economy is not the same. Few people have more tendency to save while the others have a tendency to spend more. An increase in income may cause some people to save more while others to spend more. If there is equal distribution of income in a country both the national saving and the investment will increase tremendously.

But in case of underdeveloped countries this does not occur. Mostly the level of saving is very low and hence investment is negligible. Therefore in the case of underdeveloped countries their governments require a huge investment for the development process that can be possible by the application of deficit financing. As the concept of deficit financing is applied there is increase in the national income of the country because of the multiplier effect that in turn increases the savings and finally shows an increase in investment leading to the development process.

Safe Limits of Deficit Financing

Deficit Financing has both positive and negative effect on the economy. On one hand it can accelerate development of any economy while on the other side deficit financing can be the reason for instability of the economy.

Deficit Financing is also popularly known as inflationary financing. It is believed that deficit financing can cause inflation and thus have a negative effect on the economy, but this is not the truth. In the course of economic development deficit financing definitely results in increase in price but it is because of several reasons. For example when deficit financing is applied on any economy the price of goods and services related to basic needs of people does not shoot up too high. Besides this when money supply is increased in the economy through deficit financing, it depends on the supply of money and monetary policy of the country. In any economy, if the supply of money is limited and the monetary policy is such that it controls inflation then deficit financing does not increase inflation that much. At the time of application of deficit financing in any economy government should consider to implement its monetary and fiscal policy in coordination so as to control inflation.

Along with the application of deficit financing the tax structure of the government should also be planned in a way that inequality in society does not wider. At the time of applying deficit financing the major investments should be in productive woks other wise there are fair chances of increase in prices in any economy.

Pattern of Deficit Financing in India

When the government proposes a deficit budget it is well aware of the fact that the total expenditures will be more than its receipts. So, to sustain the burden of the budget deficit because of increased expenditure the government adopts various programmes and policies. The process of supporting the budget deficit of the country is called deficit financing. After the great depression period of 1930's the different economies of the world used deficit financing for various purposes. At present there is no economy in the world that does not use deficit financing to support various programmes and policies of the economy.

Table -1

Deficit Financing during Five Year Plans

(Rs. Crores)

Plan Period	**Deficit Financing**
First Five Year Plan (1951-56)	333
Second Five Year Plan (1951-56)	954
Third Five Year Plan (1961-66)	1,133
Annual Plan (1966-69)	682
Fourth Five Year Plan (1969-74)	2,060
Fifth Five Year Plan (1974-79)	3,560
Annual Plan (1979-80)	1,355
Sixth Five Year Plan (1980-85)	5,000
Seventh Five Year Plan (1985-90)	14,000
Annual Plan (1990-92)	17,804
Eighth Five Year Plan (1992-97)	20,000

Source: Reports on Currency and Finance, Reserve Bank of India

Table- 2

Trends in Deficit and Financing of the Deficit

(Rs. Crores)

Year	Budgetary Deficit	Revenue Deficit	Primary Deficit	Fiscal Deficit
1990-91	**11,347**	**18,562**	**16,108**	**37,606**
2000-01	**NIL**	**85,233**	**19,502**	**1,18,816**
2010-11	**NIL**	**2,52,252**	**1,39,568**	**3,73,590**
2015-16	**NIL**	**3,94,471**	**99,503**	**5,55,648**

Source: Economic Survey (2004-05 and 2015-16)

In the Indian context, the first five year plan began in 1951, the resources were very limited and therefore huge investment was needed for the development purposes. At that time deficit financing was the only measure for development. So in the first five year plan deficit financing was of Rs. 333 crores. The objective of the second five year plan was mainly on the industrial development. At that time the prices were stable so deficit financing of Rs. 954 crores was done. At the time of the third year plan it was being realized that the income of the people was increasing and the resources of the country was increasing as well, so the savings were also increasing. Therefore there was need of lesser deficit financing as compared to the previous years. It was felt that deficit financing should be for an amount that will fulfill the shortage of investment. But, in 1962 war with China and in 1965 Pakistan war and drought in various parts of the country resulted in the rise in the prices at a high rate forced the government to increase the limit of deficit financing. The fourth five year plan emphasized on sustainable development. The agricultural output was also at the record level and so deficit financing was less than compared to the estimated amount. In the fifth five year plan the country was facing a period of economic instability. The production of foodgrains was low and the oil prices at the international level were on the rise. The increase in money supply because of deficit financing was also the reason for increase in inflation. In the sixth five year plan there was rise in the national output and the public revenue also increased and so the shortage in resources was fulfilled. Accordingly, as estimated deficit financing of Rs. 5,000 crores was only needed. The government in the seventh five year plan kept a target of 5% growth per year that required an investment of Rs.1 lakh 80 thousand crores. But the government did not have the required resources so deficit financing of a huge amount was required to sustain the growth rate. In the eighth five year plan, deficit financing was lessened, the main reason of which was debt crisis. On one side, the interest payments of the Government of India were 3.9 % of GDP while the non- planned expenditure (subsidy) became 3.6% of GDP. So, all the above facts were considered to limit the amount of deficit financing.

In the ninth five year plan, on the recommendation of Sukhamoy Chakravarty, the concept of deficit financing was changed. On 1st April, 1997 the deficit financing was not measured as budgetary deficit but as fiscal deficit. It was considered that the budgetary deficit does not reflect the real position of the economy because increase in the liability of the government was leading to increase in the expenditure in the non- planned budget and so the deficit financing began to be measured as fiscal deficit. The issuance of ad-hoc treasury bills was discontinued from 1st April, 1997. Instead at the time of temporary revenue short falls the government at Central and State levels could borrow through ways and means, advances for the duration of 15-90 days. In 1990-91 when the old concept of deficit financing was being applied the budgetary deficit amounted to Rs.11,347 crores while the fiscal deficit amount was 37,606 crores. In 2000-01 fiscal deficit was Rs. 1,18,816 crores and in 2015-16 it was Rs. 5,55,648 crores. On the other hand in 2000-01 revenue deficit was Rs. 85,233 crores that became Rs. 3,94,471 crores in the year 2015-16. The primary deficit of the Government of India was rupees 16,108 crores, which reduced from Rs. 1,39,568 crores in 2010-11 to Rs. 99,503 crores in 2015-16.

Conclusion

The above discussion we makes it clear that it is not prudent for any government to run a very huge deficit, but in case of a developing country like India it is also not important to have surpluses at the cost of long term growth. There is no simple answer to whether a budget deficit is helpful or harmful, it depends on the nature of the economy and the on the way in which the government utilizes the fund received from deficit financing. If the government borrowed to invest in improving infrastructure it may be able to overcome market failure and improve the productive capacity of the economy and the return from the public sector investment may be greater than the cost of borrowing. In the Indian context deficit financing and economic development show a positive relation. At the time of the commencement of the five year plans, the resources were limited at that time government used deficit financing to generate finance which was used to develop infrastructure and also in social investment as a result of which the Indian economy attained the position of one of the world’s strongest economies.

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