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# Economies of fiscal budget

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**Abstract**
The paper works on the emergence of deficit financing after the commencement of World War I and II. It gives an historical analysis of how deficit financing affected the productivity of Industrial countries, the deficit increased to such exorbitant levels that it touched 50 to 60% of the GDP, of the many western countries. This resulted in putting the pressure on social policies and the unemployment increase in most of the countries which are studied in this chapter. The paper gives a descriptive view of the theories based on deficit financing. It was essential for the world to reduce its deficit, and hence the concept of reducing the percentage of deficit finance to Gross Domestic Product came forward. India in the year 2000 put forward the FRBM Act, which made it compulsory for the government to make the deficit lesser and lesser. Though in spite of these ruling and Act, the deficit has been increasing though the percentage in terms of GDP may be coming down. Yet the paper describes, that what are the basic sources of deficit financing and since the inflation has to be kept in check, the Monetarist and the finance department, has to play the tug of war.

**Keywords:** Deficit finance, gross domestic product, sources of deficit financing, theories of deficit financing

## 1. Introduction

Budget is Avery important aspect of a state and public finance. Economics explains the income receipts and expenses and expenditure, detailed out for the purpose of past and future analysis of growth either positive or negative. The analysis takes the budget details and tries to understand the reasons of surplus and deficit.

Fiscal deficit is defined as the excess of total expenditures over the total receipts, excluding the borrowings in a year. In other words, this can be defined as the amount that the government needs to borrow in order to meet all expenses. The more the fiscal deficit, the more will be the amount borrowed. A budgetary deficit is referred to as the situation in which the spending is more than the income. Although it is mostly used for governments, this can also be broadly applied to individuals and businesses.

In other words, a budgetary deficit is said to have taken place when the individual, government, or business budgets have more spending than the income that they can generate as revenue. The fiscal budget, are of three types fiscal deficit, revenue deficit and primary deficit. Fiscal deficit is the excess of total expenditure over the total receipts, leaving aside the borrowings of the year.

Revenue deficit is the excess of total revenue expenditure over the total receipts. Primary deficit is the current year fiscal deficit subtracted by the interest payments which are pending on previous borrowings.

## 2. Historical background

It was way back in the nineteenth century and the early twentieth century, fiscal deficit were very small, especially in major industrial countries which would include Italy, Japan, the uk, and the USA. The trend line of fiscal deficit would show a smooth trend line. However, World War I (1914-18) altered the scene altogether. The borrowings increased, this was further made worse during the II world war, where fiscal deficit became a trend and it was very difficult for the countries to go back to the fiscal deficit less economy.it was in 1960 and 1970, the normal peace time of fiscal balance concept was completely eroded.

Facing fiscal Deficit [1], it is the outcome of political policies and to please the voters in democratic setup, that fiscal deficit has become the rule of the day. Projected increase in policies and government plans coupled with social programmes for aging population, economic growth lags have further accentuated the growth in fiscal deficit.

Further, the growth in fiscal deficit, have been growing as a percentage of gross domestic product. The Oil crisis in the middle of 1970, further increased the deficit. The government overspending coupled with meagre tax collection, the industrial countries fiscal deficit increased from twenty eight percent of GDP to fifty percent of GDP in 1994.

## 3. Causes of continuing deficit

It is the belief and the reason, which most developed economies, perceive that the main cause of decoration in the fiscal deficit, has come forward due the change in the demographic trends and the changes in the macro-economic policies which has been put forward by the learned educationist and adopted by the government. In order to cater to the changes in fiscal deficit the root problems need to be addressed.

The main causes for the countries to have a higher level of fiscal deficit can be seen in the following table.

The above table which has been taken from US department of Commerce, the table puts forward that the fiscal deficit spending has been on Defence and International Relations, Education, Welfare, Health, Interest on Debt, Insurance trust Expenditure and others. Out of which the higher percentage has gone to defence and international Relations, Education.

### 3.1 Demographic shifts

In the advanced countries the government transfers for social security and affordable health care to the population is regarded as entitlements and hence they are used by the politicians to propagate their agenda on the cost of increasing interest cost. Further the current demographic trends display that the aged population is increasing as the death rate is reducing. This results in higher spending on aged population.

### 3.2 Macro-economic changes

In the decades of 1950s and 1960s, the unemployment was at less rate and inflation was also low, economic growth was high. The rise in income was more than the rise in inflation. People had belief in the government, and believed that the social security will be adequately provided. These fixations and ideas resulted in low revenues and more expenditure.

### 3.3 Productivity slowdown

After the 1970 Oil crisis the productivity of the workers of the Industrial countries were slowly coming down, the rise in inflation had resulted in difficulty to handle price hike pressures. Productivity is linked with better and more effective hours, rather than long hours, with less facility. For various reasons, productivity growth further fell down, government policies and private sector policies of undermining incentives in the hope of gaining productivity were the main cause of low productivity, the improvements were very small and hence depressed the growth rates of these countries.

### 3.4 Debt and inflation

As the inflation increases there is a price hike, which is very irritating and worrisome for the consumers, but the ruling political party bask themselves in this glory as the debt taken at fixed interest rate becomes cheaper. So, the two sides keep pulling each other and it turns into a tug of war, between the commoners and the ruling democratic party. The following table explains the GDP and debt ratio: (Please see next page)

Taking debt has become normal for the ruling parties, it is no longer considered as the medicine for economic recession or to be used during national emergencies. The government has been using it as the sine quenon of fiscal policy. This has put forth an increase in public debt to worrisome levels. The France's Debt GDP ratio, in 1985, France carried a debt equal to 32 percent of its GDP; by 1994, the debt had reached 48 percent--a 50 percent increase over nine years. France's economy grew more slowly during this period, so that the country's debt burden is growing faster than its ability to pay it off. Table 2 presents the debt ratios of a number of industrial countries.

Given demographic trends, the industrial world faces an increasingly uphill battle against debt accumulation. By 2010, most pay-as-you-go public pension plans are predicted to come under severe strain, and the demographic peak is not expected until a few decades after that. By 2050, given current trends, nearly one in three people in the industrial world will be 60 or older. For the United States, social security liabilities in 2010 are projected to reach 167 percent of its gross domestic product, while future contributions and current assets are estimated at 136 percent of GDP, leaving a gap of 31 percent that must be met by higher taxes or lower benefits. Most other industrial countries must navigate even more treacherous fiscal straits. If one adds to these difficulties health care benefits paid to the elderly, the prospect becomes downright bleak. Ultimately the taxes needed to support current government commitments will fall on tomorrow's taxpayers. Consequently, some observers fear that intergenerational conflict may be on the horizon.

### 3.5 Structural unemployment

Employment fluctuates with the fall and rising of corporate earnings, in the business cycle at the trough level, production is curtailed, and workers are laid off. The resulting unemployment though short term at the beginning puts a stress on the government budgets. The unemployment puts pressure on the social security plans. However, even at the boom time the unemployment levels never touch the zero level and so an average rate is around 2 to 3 percent at the international levels, leading to structural unemployment. It is believed that the growth of social welfare programs in the 1960s and 1970s stimulated a decline in the stigma attached to long term unemployment and government dependency. Thus the social welfare programmes have become perpetual in nature.

[1] IMF Working Paper 95/128, "Long-Term Tendencies in Budget Deficits and Debt," by Paul R. Masson and Michael Mussa

**Table 1:** U.S. Government Expenditures, Selected Years, 1902-92

| | Total in Billions of Dollars | Percent of Total | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | Defence and International Relations | Education | Welfare | Health | Interest on Debt | Insurance Trust Expenditure | Other |
| 1902 | 1.66 | 10 | 16 | 2 | 4 | 1 | -- | 67 |
| 1942 | 45.58 | 58 | 6 | 3 | 2 | 3 | 2 | 26 |
| 1975 | 560.1 | 17 | 17 | 7 | 4 | 6 | 19 | 29 |
| 1992 | 2,487.9 | 13 | 14 | 8 | 5 | 10 | 22 | 28 |

**Source:** U.S. Department of Commerce (1975, 1987, 1994)

**Table 2:** Government Debt as a Percent of GDP, 1980-94

| | 1980 | 1985 | 1990 | 1994 |
|---|---|---|---|---|
| Belgium | 81.6 | 112.6 | 128.4 | 136.0 |
| Canada | 44.3 | 64.7 | 73.1 | 95.6 |
| France | 20.8 | 31.0 | 35.4 | 48.4 |
| Germany[1] | 31.8 | 41.7 | 43.4 | 49.8 |
| Greece | 24.2 | 50.6 | 73.9 | 114.1 |
| Italy | 57.8 | 82.3 | 102.1 | 129.0 |
| Japan | 52.0 | 68.7 | 69.8 | 83.3 |
| Netherlands | 46.6 | 71.5 | 78.8 | 79.4 |
| Norway | 52.2 | 40.7 | 39.2 | 50.1 |
| Spain | 17.5 | 45.1 | 45.1 | 62.8 |
| United Kingdom | 49.6 | 52.7 | 34.4 | 46.0 |
| United States | 43.6 | 51.5 | 59.9 | 68.9 |

[1]Data refer to western Germany through 1990, united Germany thereafter.

## 4. Implications of budget deficit

would mean that though the government undertakes deficit, it results into increase in aggregate demand, it also boosts the economy during recession, this results in increase in Government spending, resulting in increase in consumption level and employment level this also leads to expansionary fiscal policy, to improve upon infrastructure and investments to make it feasible for the foreign capital to invest in the country boosting in economic growth. This would result in higher taxes in the future, higher interest rate and higher bond yields.

## 5. Theories of budget deficit

**Ricardian Equivalence theory:** Ricardo Theory, states that taking deficit by the country in fact does not help, in the economic growth, based on certain assumptions. The theory puts forward that consumers are forward looking and hence they internalize the state budget. Hence when the state takes a deficit budget, the brunt is shared by the consumers of that country.

### Crowding out Theory

The Crowding out Theory states that an increase in government spending and borrowing leads to a decrease in investments from the private sector. It is because governments borrow by selling bonds to the private sector and by borrowing from foreign sources, such as other countries and international banks.

However, it often results in higher interest rates, as well as higher spending on bonds by the private sector – which leads to lower funds for private sector investments and a higher cost of borrowing (due to higher interest rates).Therefore, the increase in government spending is often met with a relatively smaller decrease in private sector investments, which offsets the overall effect of the expansionary move.

## 6. Literature review

In the book of bureau of International Settlement, fiscal deficit and Inflation rate, the data of advanced economies for four decades has been analysed, which states that the fiscal deficit depends on the policy enacted by the government on fiscal and monetary terms. If the government does not has a policy on price stability and the central bank is under the hands of the state head and therefore has less independence, the growth in fiscal deficit will increase, and the inflationary trend is going to increase five times. During the Covid19 pandemic high inflation has been witnessed with the countries where the fiscal dominance has been high rather than monetary dominance [2].

Another paper by International Monetary fund, fiscal Deficit and Inflation [3], states that macro-economics states that fiscal Deficit increases Inflation, but on empirical analysis, which was done on 107 countries, the paper through non linearity model states that the countries with high inflation has high fiscal deficit. However, this is not in the case of highly developed countries where the inflation is not high.

A paper on 'An Analytical Study of Gross Fiscal deficit of India' [4] Fiscal deficit is the major considerable element on economic growth as well as country's purchasing power. The better control on deficits may warrant the stability in growth as well as effective control on inflationary pressure. The paper is primarily aims to review the trend and patterns of fiscal deficit (Gross) of Central Govt. the period extended for this was 1995 – 96 to 2018 – 19. The period is classified into 3 phases. Phase-One 1995-96 to 2002-03 post liberalization period but before implementation of FRBM Act. Second phase two from 2003- 04 to 2010-11 a period between post implementation of FRBM Act and economy recovery post global financial crisis. While phase three post global financial crises. The relationship between the quarterly deficits of three periods has been identified for all four quarters. It is observed that three quarters have no significant difference while when the data is tested for annual deficits the variation was found significantly different. The major recommendable aspect is that funds borrowed shall be effectively utilized for funding capital expenditure as against the financing fiscal deficit.

[2]BIS Working Papers No 1028 Fiscal deficits and inflation risks: the role of fiscal and monetary regimes by Ryan Banerjee, Valerie Boctor, Aaron Mehrotra and Fabrizio Zampolli Monetary and Economic Department July 2022

[3] IMF working Paper, Research Department, ' Fiscal Deficit and Inflation'; Catio l.& terrones M.E., April,2003

[4]https://archives.palarch.nl/index.php/jae/article/download/3205/3209/6204

In the Paper [5]. This paper attempts to analyze the impact of the fiscal deficit on GDP growth of India and the relationship between fiscal deficit and GDP growth in India. The study is based on secondary data that has been gathered from IMF (International Monetary Fund) and World Bank from the period of 1995 to 2016. In this paper, for analyzing the impact of fiscal deficit on GDP growth in India the OLS estimator of simple regression model has been used. Besides, for examine the relationship between these two variables the Pearson's correlation model has been used. Before running the regression model, the ADF (Augmented Dickey-Fuller) unit root test used. And found that the data at level point were not stationer for both variables. Then, for fiscal deficit 1st difference and for GDP 2nd difference have been used. The paper also found, fiscal deficit does not have effect or influence on the GDP of India in that period of time and it just put 4.1 percent impact on GDP growth of India. Further, the paper also examined that there is no significant relationship between the variables. But the relationship was positive in nature and with moderate percentage that was around 21 percent.

In the paper [6], the authors have analysed the fiscal deficit and growth in GDP Issues, and its analysis explains that the growth in primary deficit hampers the growth of an economy as primary deficit is fulfilling deficit to fulfil the Interest payment. It is therefore evident that this will slow down the growth rate in GDP, and shall hamper the progress of the country.

This study has been undertaken so as to establish the impact of fiscal deficit on the growth of gross domestic product. In order to achieve the objective of the study, the researcher has taken a reference period of fifteen years from 1999-2000-20013-2014. The researcher has employed linear regression model and Pearson's correlation model. The findings of the study through linear regression model confirm that the independent variable (Fiscal Deficit)is significant in causing a change in the dependent variable (Gross Domestic Product).Besides, the results of Pearson's correlation model also affirm a negative relationship between the variables under study at 0.05 level of significance. The findings of the study corroborates with the findings of Mohammad *et al.* (2010) [10], Vincent *et al.* (2012) [8], Gemme (2001) [9], as all these studies also established a negative relationship between fiscal deficit and gross domestic product**.**

## 7. India's fiscal deficit

**Since 2020, India's fiscal deficit has increased**

India got its freedom, on 15th August 1947, from the year 1937-38 to 1946-47, the provinces, so called at that time were with surplus budget. However, the central budget has been in deficit as the major portion has been on Defence. This has been represented in the following table7.

**Table 3:** Revenue and expenditure of provinces with the revised estimates

(In lakhs of Rupees)

| Province | Provincial Revenue | Devolution Grants from the Centre including Dev. Grants | Total Revenue | Total Revenue Expenditure | Cumulative Deficit(—) Surplus (+) | Balances in Reserve Funds on 31st March 1947 | Closing balance on 31st March 1947 |
|---|---|---|---|---|---|---|---|
| Madras | 2,63,27 | 24,12 | 2,87,39 | 2,84,22 | +3,17 | 29,18 | 56 |
| Bombay | 1,92,52 | 26,51 | 2,19,03 | 2,06,69 | +12,34 | 17,07 | 42 |
| Bengal | 1,65,35* | 69,92 | 2,35,27 | 2,51,13* | —15,86 | 25 | 2,48 |
| United Provinces | 1,79,33 | 26,77 | 2,06,10 | 2,04,99 | —1,11 | 17,31 | 6,43 |
| Punjab | 1,84,12 | 11,51 | 1,95,63 | 1,60,46 | —35,17 | 6,79 | 57 |
| Bihar | 75,06 | 15,10 | 90,16 | 81,81 | +8,35 | 7,78 | 1,07 |
| C. P. & Berar | 63,61 | 7,69 | 71,30 | 70,66 | +64 | 8,14 | 2,41 |
| Assam | 35,54 | 7,89 | 43,43 | 42,89 | +54 | 1,02 | 1,54 |
| N. W. F. P. | 11,94 | 11,55 | 23,49 | 22,95 | +54 | 15 | 63 |
| Orissa | 17,71 | 7,93 | 25,64 | 25,11 | +53 | 10 | 60 |
| Sind | 55,19 | 10,27† | 65,46 | 60,04 | +5,42 | 8,14 | 8 |

*Subsidy of 3,00 in 1943-44 taken by Bengal as reduction of Expenditure on Famine Hence Revenue and Expenditure both have been increased by 3,00.

†The subvention was capitalised on 1st April 1944 and the value set off against the Lloyd Barrage Debt.

Revised Estimates have generally been taken for 1946-47.

**Source:** Rao Shiva B., "The Framing of India's constitution Select Documents Volume 3'.Pg 292; Delhi, Universal law publishing co. Pvt. Ltd.; 2004.

The above table depicts the revenue and expenditure, of provinces with the revised estimates taken for 1946-47. The Madras province had a revenue of Rs; 2,63,27; Bombay Province with Rs; 1,9252; Bengal province Rs: 1,65,35, United provinces had Rs: 1,79,33; Punjab, Bihar, Central provinces & Berar, Assam, North West frontier provinces, Orissa and Sind had a revenue of Rs: 75,06 lakhs, Rs: 63,61 lakhs, Rs: 35,54 lakhs, 11,94 lakhs; Rs: 17,71 lakhs; and Rs: 55,19 lakhs, respectively. Closing Balance had been to the tune of 56 lakhs, 42 lakhs, 2, 48 lakhs, 6,43 lakhs, 57 lakhs, 1,07 lakhs, 2,41 lakhs 1,54 lakhs, 1,54 lakhs, 63 thousand, 60 thousand and 8 thousand respectively (Allin Rs).

**Table 4:** (b) Central government (1937-38 to 1946-47) (In lakhs of rupees)

| Year | Revenue | Expenditure | | | Deficit(-) Surplus(+) |
|---|---|---|---|---|---|
| | | Civil | Defence | Total | |
| 1937-38 | 86,61 | 39, 39 | 47, 22 | 86, 61 | . |
| 1938-39 | 84,52 | 38, 97 | 46, 18 | 85, 15 | -63 |
| 193-40 | 94,57 | 45, 03 | 49, 54 | 94, 57 | . |
| 1940-41 | 1,07,65 | 40, 57 | 73, 61 | 1, 14, 18 | -6, 53 |
| 1941-42 | 1,34,57 | 43, 33 | 1, 03, 93 | 1, 47, 26 | -12, 69 |
| 1942-43 | 1, 77, 12 | 74, 28 | 2, 14, 62 | 2, 88, 90 | -1, 11, 78 |
| 1943-44 | 2, 49, 95 | 81, 44 | 3, 58, 40 | 4, 39, 84 | -1, 11, 89, 9 |
| 1944-45 | 3, 35, 71 | 1, 00, 77 | 3, 95, 49 | 4, 96, 26 | 1, 60, 55 |
| 1945-46 | 3, 67, 18 | 1, 24, 36 | 3, 60, 23 | 4, 84, 61 | -1, 23, 43 |
| 1946-47 | 3, 36, 19 | 1, 43, 36 | 2, 38, 11 | 3, 81, 47 | -45, 28 |
| Total | 19, 68, 07 | 7, 31, 52 | 18, 87, 33 | 26, 18, 85 | -6, 50, 78 |

**Source:** Rao Shiva B., "The Framing of India's constitution Select Documents Volume 3'.Pg 292; Delhi, Universal law publishing co. Pvt. Ltd.; 2004

The next table explains the deficit from1937 to 1946 and it can be observed that the total deficit amounted to Rs: 6, 50, 78 only. Hence, on the eve of independence India was on heavy debts and with the partition and wars faced by the country the debt increased further, with very few infrastructural growth.

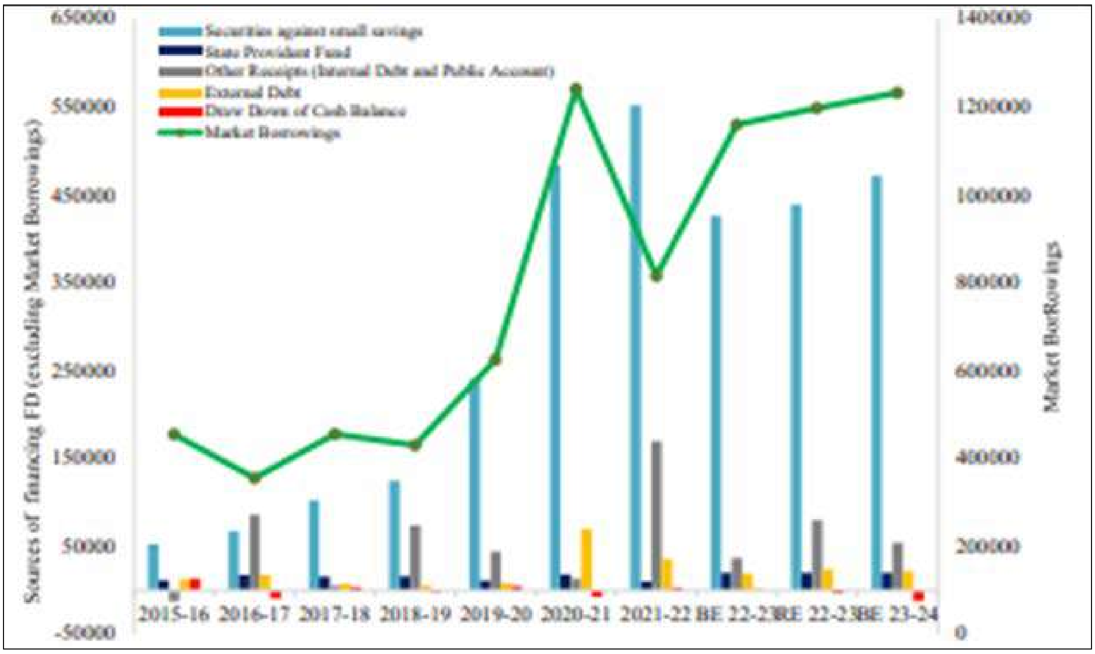
## 8. India's deficit financing during the past ten years from 2013 to 2023

5https://www.researchgate.net/publication/348960265_India's_Fiscal_Deficit_and_its_Impact_on_Gross_Domestic_Product_An_Analysis

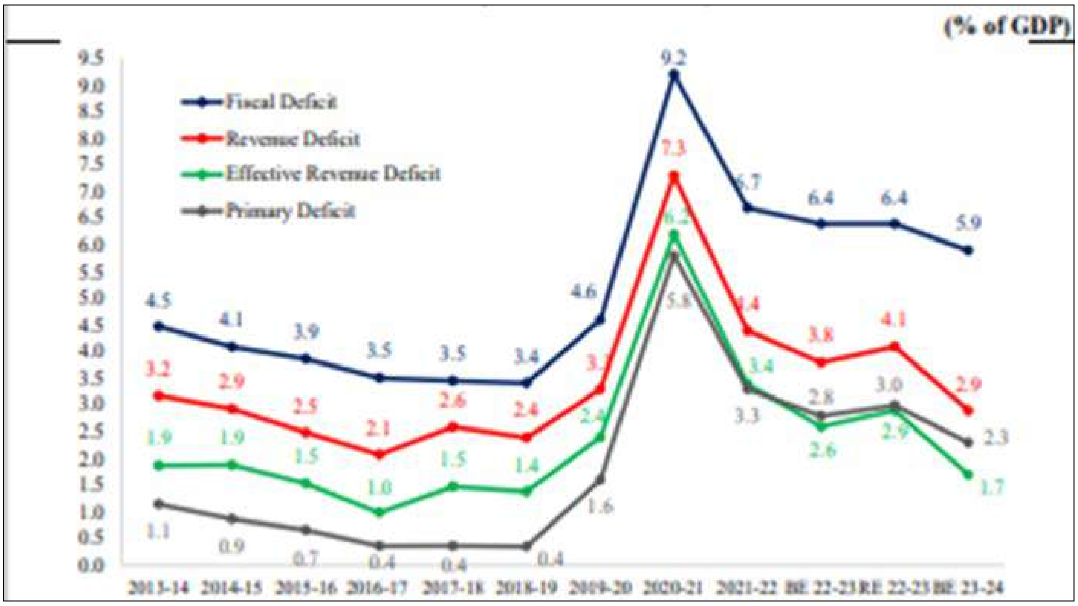
6https://www.jstor.org/stable/i401300

7 Rao Shiva B., "The Framing of India's constitution Select Documents Volume 3'. Delhi, Universal law publishing co. Pvt. Ltd.; 2004

Sources of India's Deficit Financing: Since 2015-16 to 2023-24, the deficit financing has been increasing continuously, the highest share has been Securities against small savings, State Provident funds, other Receipts, External Debts, market borrowings as can be seen from the following graph.




**Graph 1:** Sources of deficit financing




**Graph 2:** Deficit trends

The graph depicts the Fiscal Deficit, revenue deficit, Effective revenue deficit and primary deficit. Though India has improved highly on infrastructural growth, but the rise in Primary deficit is a cause of great concern.

## 9. Conclusion

The descriptive paper is an insight on deficit financing ranging from historical evolvement, with the present state of deficit financing of India. The socio political programmes, unemployment scenario all needs to be taken care of, it is a point to be taken into consideration that the citizens of the world should see to it that they should avoid the free lunch, which is provided to them on the cost of taxation and hampered productivity. The paper has full concern for the elderly and other citizens who are in need of state support. However, the population who can work and can avail facilities on their own, should not become a burden on the state. The other most important thing is the government administrative machinery should cut them off themselves from corruption and to make the country their priority.

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