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- CHAPTER - II -

- THEORY AND OPERATION OF DEFICIT FINANCING -

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2:1 INTRODUCTION :-

In the theory of public finance; fiscal policy assumes very crucial role. The fiscal policy is used to cure various ills arising out of - implementing monetary as well as revenue exp - enditure process of government. In the box of fiscal policy; deficit financing is one such instrument which is used for various purposes in various periods without taking into consideration its throughly theoretical and other varied aspects. Till now the tool of - deficit financing has not been studied with reference to taking into account its pres and cons in detail. Here we shall try to - explain the conceptual framwork of deficit financing and various issues connecting with it while implementing it in the public finance.

2:2 CONCEPT OF DEFICIT FINANCING :-

The Distinction between Deficit Budgeting And Deficit Financing :- While taking into consideration the meaning and conceptual framwork of deficit financing built by different economists; it is essential first to explain the difference between the two terms i.e. deficit budgeting & deficit financing

When Government expenditure on current account exceeds the government revenue on current - account, it is called deficit budgeting. In deficit budgeting capital items on the revenue side.

Deficit financing; on the contrary is a more comprehensive term. It takes place when the aggregate expenditure of the government both on current and capital account exceeds the - aggregate income of the government both on current and capital account. Here one thing is clear that deficit financing is mostly re - lated to the budgetory provisions of the cen- tral government. Thus the deficit financing is one such method with the help of which bud- getory gap is filled up (covered). Deficit - financing refers to the ways according to which the budgetory gap is financed.

F. of excess of [illegible] Exp. over [illegible] revenue from fees, Taxes, [illegible] borrowing from RBI on the basis of T. bills

DEFINITION OF DEFICIT FINANCING :-

In Shri. J.L. Hanson's 'A Dictionary of - Economics & Commerce' he has defined the - concept of deficit financing as a delibera- tely budgeting for a deficit. "Fiscal Policy through the budget is now a recognised adjunt to monetary policy. To check inflation the

aim has often been to obtain a large budget surplus to reduce the volume of b purchasing power in the hands of consumers. Faced by the trade depression and serious unemployment it has been suggested that a budget deficit should be deliberately incurred, taxes being reduced in order to make more purchasing power available as a stimulus to demand.
According to Dr. V.K.R.V. Rao, the phrase - deficit finance is used to describe the financing of a deliberately created gap between public revenue and public expenditure; or a budgetory deficit, the method of financing resorted to being borrowed of a type that - results in a net addition of national outlay or aggregate expenditure.[11]

The Indian planners have defined the term - deficit financing in the following manner. "The term 'deficit financing' is used to denote the direct addition to gross national expenditure through budget deficits, whether the deficits are of revenue or on capital - account. The essence of such a policy lies, therefore, in government spending in excess of the revenues it receives in the shape of taxes, earnings of the 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 borrowings from the central bank of the country and thus creating money."

Thus various means of Deficit Financing are as following:-

1) Net Borrowing from the public.
2) Use of cash balances from Central Bank.
3) Net Borrowing from the Central Bank.
4) Issue of currency notes directly by - government.

WESTERN APPROACH :-

Thus, these various definitions of deficit - finance highlight the different basic issues and aspects which are attached to the concept and by different countries. For examples, in the Western countries, Government revenue excludes receipts from the loan, deposits and liquidation of financial assets, And Government expenditure excludes payment on account of - loans given out or repaid, withdrawal of deposits and acquisition of liquid assets. In these countries budget deficit, arised out of government outlay over the Government revenue, are financed through market borrowings. Such a deficit is nothing but transfer of money and real resources from the people to the Govern - ment sector. Thus in Western countries, the concept of deficit financing involves essen - tially credit expansion, which is of course, - utilised to finance private capital formation. And normally speaking, deficit finance is under- taken more to deal with situations arising out of war, business cycle or compensatory finance than to finance economic development process in daily routine.

INDIAN APPROACH :-

The Indian planners have first time attempted to give an entirely different interpretation to deficit financing. The deficit financing in the Indian sense occures when the budget - deficit is financed by the Government through creation of new or additional money.

The public borrowing is excluded from the - deficit financing. It is not counted in the deficit financing. In otherwords, the deficit in budget and plan is covered by creating addi- tional supply of money, which causes increse in the purchasing power of the people. It means the utilisation of public debt is not concerned with deficit in India.[11]

The deficit financing, In Indian context take place in any or all the following ways :-

i) The government may withdraw its cash balances from the Central Bank.

ii) The Government can borrow the funds from the Reserve Bank of India.

iii) The Government may resort printing press to print additional currency notes, with a view to covering the budget deficit.

In this way, the term deficit financing is used to denote the direct addition to gross national expenditure through budget deficit, no matter whether the deficit are of revenue or of capital account. The essence of such policy lies therefore, in government spending of in excess of revenue it receives in the shape of taxes, earnings of the 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 borrowings - from the Reserve Bank of India.

2:3 THEORY OF DEFICIT FINANCING :-

The different shades of the opinions have been expressed conveniently to frame the concept of deficit financing. So there are different views about the contents, utility and effectiveness of the deficit financing. The economic history of various countries reveals that the 'deficit financing' has world wide accepted - recource for the purpose of economic development of the country. Though theoretically it it is assumed an essential activity now, at the very beginning it was hated in various ways. Now a days in all the countries the tool of deficit finance has become an indespensable part of their public finance. Thus there are mainly two views theoretically established regarding the pros and cons of the deficit financing. One may be put up as classical theory of deficit financing and the others as modern approach/theory of deficit financing.

THE CLASSICAL THEORY OF DEFICIT FINANCING :-

No single name can be enlisted for the complete and comprehensive establishment of theory of - deficit financing from the classical school. But in varied forms, shapes of the opinions - explained by them are somewhat enough to build the classical theory of deficit financing. The classical economists held the view that - the budget should be small and balanced for rather all the times. This a belief of classicist was based primarily on the view that as princes and republics waste the material resources by frivolus spending and by launching ambitious spending programmees, like war, deficit would tend to be inflationary. Basically all the classical economists believed that, deficit financing would lead to rising prices and as such would tend to be a low national esteem. As the classical economist had a firm belief in the free market economy, which generally denies the state intervention, leads to such conclusion that it is fair to have small and balanced budget of Government. By opposing unbalanced budget they have expressed their views about the implementation of deficit - financing. According to the Adam Smith funds which would otherwise be productively invested. He also maintained that ability to engage in debt operations makes the state irresponsible and that their arises long run danger in debt. But he has not considered that matter of creation of new money. J.B. Say also opposed - debts and deficits, because he held that debt has a burden of servicing of debt. Ricardo - believed that once the debt had been incurred there would not accrue any economic advantage from retiring it. Thomas Malthus, however, - declared that national debt was not an evil as was supposed. J.S. Mill thought that the budget deficit in various forms could be - regarded as harmful, if it destroyed capital; which could have been otherwise used for productive purposes.[10]

Alfred Marshal's opinion is different from - that of Adam Smith. He stressed that the role of credit in modern days had considerable changed from that previous one. Bastable in 1892 - maintained that under certain conditions loan finance is essential one. He said when there are large and non recurrent expenditure, where the expenditure extends over a number of years, the need of budget deficit emerges absoulutely.

MODERN THEORY OF DEFICIT FINANCING :-

The onset of the Great Depression of 1930's - and emergence of Keynesian economics gave a new sight to deliberately unbalanced budget. Deficit financing, therefore, assumed great importance as a recovery measure. It was - assumed from Keynesian economics that each aspect of government finance may be used as an instrument of economic policy to influence the size of the nation's income or to change the structure and character of the nation's output. Thus the orthodox policy of balanced budget not having deficit was supposed unsuitable during the period of business fluuctuations. To remove ills of business cycles and to control upward and downward movements of the fluctuating economy, there was advocated the policy of unbalanced budget covering essential amount of the deficit financing. Lord Keynes through his scholarly book 'The General Theory of Employment. Interest and Money criti-cised the classical propositions and showed that for creating higher and vast opportunities of employment, the government's public expenditure through deficit spending should essentially - increased. Further he added that fiscal measure give appropriate direction to the economy and for this purpose government should handle carefully the resource of deficit financing. - Thus the deficit financing in the form of the compensatory finance, activating finance and functional finance were urged to solve werious problems ofthe country. He claimed that Government may resort to deficit financing for different purposes.

Post Keynesian economists still further stress the need of deficit spending in the process of economic development. Hanson, Samuelson, Wallich especially argues that, when idle resources exist in the economy alongwith the unemployment and low spending power of people, there is need of increasing public outlay which will have a sure employment creating effects. And for such excess public outlay than revenue; government may resort to the deficit financing such a - deficit budget would have a greater multiplier effect than an equally large balanced budeget. Further, an increase in income caused by a - deficit budget may have a greater acceleration effect than in the case of balanced budget. Hanson in acceleration principle suggest that increased purchasing power in the form of - consumer expenditure created through deficit spending leads to establishing new industries and spheres of employment.

2:4 IMPLICATIONS OF DEFICIT FINANCING :-

The study of the implications of deficit financing may be undertaken with various approaches and impacts of the deficit financing on the - various sectors and aspects of the national - economy. Broadly speaking following categoreis regarding the implications of deficit financing are taken into consideration.

i) Monetary implications of deficit financing.

ii) Inflationary implications of deficit financing.

iii) Employment generating implications.

i) MONETARY IMPLICATIONS :-

From the point of view of monetary implications of deficit financing, it is seen that, the - immediate result of it is in increasing - (creating) additional currency and credit. This additional currency enables government and - credit. This additional currency enables government to outbid consumers in the procurement of resources and use them for the capital formation. Thus as a result of creating deficit financing there rises the supply of money. But actual expansion in monetary circulation which may - affect from a given amount of deficit financing will, however, depend on the behaviour of various factors influencing money supply, such as credit policy, public debt policy of commercial banks, the state of balance of payment etc. Thus the - monetary policy, that are used from time to time for respective purposes.

II) INFLATIONARY IMPLICATIONS OF DEFICIT FINANCING:

When aggregate outlay in an economy increases through deficit financing, it leads to a succ - essive increase in consumer spending through the operation of the multiplier principle.

While other things remain same and only money incomes of the people raises as a result of - deficit financing, there is rise in purchasing power of the people. That raised purchasing - power straight way leads to inflationary situation. But under certain conditions, the volume of dificit financing may not result in increasing purchasing power of the people. For - example, when government expenditure is of the nature of a grant to certain credit or finance institutions, which is not immediately utili - lised, then total spending in the community - will not increase. Secondly increased volume of the deficit is spent for foreign exchange and saved through respective devices, then also that would not be inflationary. How much deficit financing would lead to inflationary situation is a much discussed problem in the history of economics. From orthodox to modern economist, all have explained the inflationary implications of deficit financing. The basic differ - ence between orthodox, neo orthodox and Keynesian school is with regard to their respective attitude towards the desirability of infla - tionary, pressure. In this matter too, the difference is not likely to be substantial.[35]

When developing economies, having with their regards, ambitions plans which are to be fin - anced through deficit financing, it is right to guide to them that they should avoid infla- tionary pressures or take actions to correct inflationary pressures.

III) EMPLOYMENT GENERATING IMPLICATIONS :-

The so called "Employment thesis" argument asse - rts that, the Fundamental economic problem of all the developing as well as developed countr- ies is one of generating more and more employ - ment in the country. Lord Keynse strongly - pleaded that until and unless public sector outlay did not increase, there would not be higher employment opportunities. As marginal propensity to consume and invest did not - increase proportionally with income of the private sector, there remains only single room for increasing employment through additional doses of deficit financing which is then used directly and indirectly in both private and - public sector.

Keynes was so confident that he said little - amount of deficit financing used as public - expenditure creates the employment opportunities according to the multiplier principle. When -

monetary policy alone proves inadequate in the period of depression, there arises the need of fiscal measures. Deficit spending by the government has assumed importance not only in recovering reduced employment but - further increasing it.

The deficit financing has assumed three forms in this context. Pump-Priming, cyclical - dificit spending and secular spending and secular deficit spending may be used to restore - employment level and made increase in employment chances. A Maintaining and increasing - level of employment is not guaranteed by only monetary policy and hence deficit financing as a fiscal tool becomes inveitable in such circumstances.

According to pump-priming theory, deficit financing results not only in primary, but also in secondary increase in income and employment. Cyclical deficit spending and secular deficit spending are elements of an overall compensatory fiscal policy designed to fill up the - deflationary gap. Here it is used not only to promote recovery, but also ~~the~~ to reduce the intensity of of the respective dangerous cyclic-cal phases. During the period of depression - and revival there is immense need for additional purchasing power and resource mobilisation. Such resource mobilisation and increasing de - mand for goods and services can be speeded - up by deficit financing in above two forms. Not only in developing economy, but in developed economy also according to Hanson there is strong powerful need of deficit financing forovercoming secular stagnation.[4]

IV) PRODUCTIVITY IMPLICATIONS OF DEFICIT SPENDING:-

In all the developing countries, the study of the deficit financing with reference to its - impact on the increase in current-production of consumption and capital goods has assumed growi-ng importance in the study of overall deficit financing. i.e. in Fiscal Policy. In the first instance, the amount of deficit financing acts as a net addition to the purchasing power which can transfer real resources from consumption to investment sector. It is very clear from this that if the amount of deficit financing is - used for the purpose of productive investment and to increase the effective demand of consu - mption goods, then such deficit financing -

contributes to increase in level of production of goods and services. As the productive invest - ment in the private sector weakens due to various reasons and in that situation the production - of various essential goods and services get the importance in the overall economy, in such situation the production of various essential goods in the public sector investment stands immense need. The government in such position can invest, through deficit financing, without too much trouble. It is righly said that, prod-uctivity implications of deficit financing can not fully prove productive until and unless the created amount of deficit financing is - used totally for the purpose of attaining - higher level of production.

2:5 IMPORTANCE OF DEFICIT FINANCING :-

It is now realised that, without the major assistance of tool of deficit financing in a developing economies, the government can hardly run fiscal operations for developmental purpose. On this background, it is easy to focus light on the importance of deficit financing in the developing as well as in developed countries. It is very clear that importance of deficit financing itself contains the good and evil effects of deficit financing in the developing economies.

ADVANTAGES OF DEFICIT FINANCING :-

Theoretical view and review of deficit financing by different schools highlights various advantages of deficit financing. If is is handled with care, it can prove a useful technique for rapid economic development. The need of use of deficit financing in depression and in war periods itself reflects the utility of the same resource. Mainly, in earlier years, it is operated for resource mobilisation. With that approach of resource mobilisation via deficit spending, it becomes possible to invest resources from less productive to more productive sectors. Through such implementation of deficit spending the pace of development is further accelerated. Many times the revenue accounts of the budget a are so poor (weak) and there is immense need of various types of expenditure. In such situation increasing expenditure can be simply met by the tool of deficit financing without much opposition, Generally, in all the under-developed and developing economies the sources of taxation and public borrowing have limited scop. The government in such circumstances have to resort to the deficit financing. And more over a little doese of deficit financing in the economy helps to increase the money supply and thus it pushes up the demands and whole process further generates the beneficial gains in the economy, in terms of higher production, employment etc. The deficit financing, by some economists have compared with the essential fuel, for machinary and as medical diet. Both ways suggests that, if the amount of deficit financing is proper and reasonable it works as a superior diet of the economy. That diet supports in accumulating capital formation and attaining higher level of employment. It also mobilises the resources from unutilised sector to more productive sectors.[@]

In short, deficit financing contributes to following spheres of the economy.

I) Resource transfer from uproductive to preductive sectors.

II) Faciliating the economic transition through essential monetisation in the economy.

III) Large scale investment in public sectors.

IV) Increase in the level of employment and production.

V) Reducing heavy burden of taxation and borrowings from domestic and external ways.

VI) Utilising available ressources to its fullest potentialities.

EVIL EFFECTS OF DEFICIT FINANCING :-

Whenever theoretically any economic resource is introduced from the point of view of its - gains in economy, it has become the things of debate. And such debate highlights the evil and disadvantageous effects of such resource. The deficit financing is not exception to it. It is very clear from very beginning of the econo - mic history that, the resource of deficit fin - ancing is criticised on various grounds. And from time to time deficit financing is consid- ered on the practical ground; from which dark shades of the deficit financing are brought into light. following are some disadvantages and evil effects of deficit financing which arises in the operation of it.

I) INFLATIONARY RISE IN PRICES :-

The most serious disadvantages of deficit fin - ancing is the inflationary rise ~~of~~ in prices, as the deficit financing increases the amount of money supply in the economy, it increases - the aggregate demand for goods and services: As corresponding supply side of goods and - services immediately does not match the demand side, it ultimately results in inflationary - rise in prices. Orthodox and schools have strongly claimed that, whenever there is de - ficit financing, it results into the infla - tionary rise in prices. But they said that it was not possible to estimate accurately the magnitude of non inflationary deficit financing by particular scientific formula. Secondly, it is impossible to plan the pattern of demand consistent with the pattern of out - put and then the deficit financing determined by the formula would lead to inflationary rise in prices.[2]

Though it is possible to study the relationship between rise in prices and deficit financing, i.e. correlation between two, the different countries in different periods show the very ing degree of correlation.

II) POSSIBILITY OF INCREASING UPRODUCTIVE INVESTMENT :-

The purchasing power as well as money supply increased through deficit financing might prove unproductive in many circumstances. The investment done out of deficit financing - prove unproductive, if it is made in long run and lengthy projects. Now a days danger of vesting the funds unnecessarily in the public sector has also posed a serious problem and in such situation funds supplied through de - ficit financing definiately prove unproductive. Of course, it is a matter of fact that, atti - tude of the government, so called socio-econ - omic condition of the country and provision for monitoring the utilisation of funds crea- ted through deficit financing shall only de - termine the possibility of increasing unprod- uctive investment.

III) DEFICIT IN BALANCE OF PAYMENT :

Here the problem is taken into account from the point of view of two approaches.

A) The extent to which deficit financing is responsible for the creation of deficit in balance of payments, via reduction of exports.

B) Payment deficits due to the inflationary rise in prices of export goods due to raised amount of deficit financing.

The eminent scholars are of the opinion that the main factor behind the deficit in balance of payment is a inflationary developments in developing countries caused by the deficit financing in the economy.* Continued deficit financing are into the vitals of potentiality of exports of developing countries. It is not always true that rising amount of deficit fin - ancing from time to time may lead to reduction in volume of exports. But generally theoreti - cal and practical view and approaches supports the out comming danger of reducing the total potentiality of export and thus raising deficit in balance of payment.**

IV) THE EFFECTS ON THE REST OF REVENUE SOURCES:

The source of deficit financing is not opposed and watchfully observed by the people in gen - eral. And so it is accepted by the government without too much puzzle. But the sources like taxation and public borrowings of revenue are always deeply considered by the government as well as public in general. The government by raising rates of old taxes and introducing new taxes do not want to take any risk (severe) about changing the opinion of people into un -

favourable atmosphere. The borrowings internal and external, also requires many things which government can not fulfill immediately. Thus the sources of revenue like that of taxation, public borrowing are not enormously utilised by the government. So government generally resorts to the deficit financing comparatively with greater ease. And this trend of the government leads to not reviewing the present structure of taxations and methods and conditions of borrowings. It further reglects the very essential evaluation of taxes and borrowings regarding the moderation (required) in it from time to time. For example, inspite of higher taxable capacity of the people and lending power i.e. internal debt of the people the government did not take raising rates of taxes and introducing new taxes. Thus due to easy source of deficit financing, government might not take essential steps to moderate the rest of revenue sources scientifically. It is understandable from study of various countries that the government of such countries revise the taxation and borrowing methods, but these are not based on real scientific study and practical approach while ~~operation~~/implementing it.

2:6 <u>CONCLUDING OBSERVATIONS</u> :-

In the efforts of development of developing and under developed economies, deficit financing thus becomes unavoidable source of - finance. Although there is a possibility that deficit financing would exert an upward pressure on prices. It need not always lead to inflation. It is moreover acceptedin history that in certain situations, even if a moderate inflation develops, it may not have a serious consequences. On the contrary, many a times it may serve a useful purpose in stimulating use of this tool creates the inflationary pressures. It means that, deficit financing should not be resorted to beyond the point at which it becomes seriously inflationary. It must be admitted that the policy of managed deficit financing with limited scope and purposeful financing with utilising approach always appears non dangerous. By keeping away the losses in terms of inflation; reduction in value of money; deficit in foreign trade and other unfavourable trends the government has to utilise the source of deficit financing for the capital formation, and raising the level of production and employment and overall economic and social development of the country. To sum up, deficit financing may be beneficial according to the purpose for which it is resorted to and its good and bad effects depend upon the effectiveness of the investment made through the deficit financing.

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