CHAPTER-IX

DEFICIT FINANCING AND FIVE YEAR PLANS

Introductory :

In this topic, certain points relating to deficit financing are discussed and analysed. The topic covers the concept or definition of deficit financing, methodology of calculating deficit financing, its use at planning and effects of deficit financing on money supply and price level. For the country like India, it is hardly sufficient to finance the process of development with resources like taxation, borrowing and foreign aid. Therefore, Indian planning Commission have given important place to deficit financing in the financing of our Five Year Plans.

Definition of Deficit Financing :

The term deficit financing has different cannotations, arising out of differences in the concept of a budget deficit. Before analysing the methodology of calculating deficit financing, let us define deficit financing in the words of Indian Planning Commission. "The term deficit financing used to denote the direct addition to the Gross National Expenditure through budget deficit, whether the deficits are on revenue or on capital account. The essence of such a policy lies in the Government spending in excess of the revenue it receives."[1] It implies that the expenditure of the Government over and above the aggregate receipts of revenue account and capital account is treated as the deficit of the Government.

Methodology of Calculating Deficit Financing :

Until recent years, a budget was considered as surplus or deficit, according to the position of the revenue accounts of the Government. Thus surplus budget was one in which revenue receipts exceeded expenditure charged to revenue; regardless of the gap in capital accounts; while deficit budget was one in which expenditure was greater than current revenue receipts. Public borrowing were not included in the receipts side. But the proceeds of the public loans utilised for bridging the gap between the revenue and expenditure were considered as deficit spending or deficit financing. In modern times, however, borrowing from the general public are included in receipts of the Government in its capital account, and if, even then there remains a gap between receipts and expenditure, the method of financing it is referred to as deficit financing. In other words the volume of deficit financing is calculated in terms of the overall deficit which means the aggregate of the deficit on both the revenue and capital account.

Deficit financing, thus refers to the way in which the budgetory gap is financed. The Government resorts to this method when it is unable to cover its total expenditure from other sources of revenue. Deficit financing, in such a case can be undertaken by Government by drawing upon its accumulated cash balances or borrowing from the Central Bank of the country or by both.

In underdeveloped countries, where banking facilities are inadequate and existing transactions are carried out through common money, deficit financing mainly takes the shape of borrowing from the Central Bank. The simple mecanism is that Government hands over its Treasury Bills to the Central Bank, on the backing of which the Central Bank issues paper currency by resorting to the printing press. The creation of deficit financing lies in its expansionary effect on the total money supply in the economy.

Deficit Financing in the Plans :

The data presented in the table No. I provides information of the deficit financing of Central and State Governments.

In the First Five Year Plan the total deficit financing was Rs. 446.8 crores.[2] (According to Planning Commission it was Rs. 420 crores). Of the total deficit financing Central Governments deficit was Rs. 407.26 crores and of State deficit was Rs. 39.54 crores.

TABLE-I

DEFICIT FINANCING (Rs. in Crores)

Item	First Plan (1951-56)	Second Plan (1956-61)	Third Plan (1961-66)	3 Annual Plans (1967,68, 69)	Fourth Plan (1969-74)	Fifth Plan (1974-79)	Annual Plan (1979-80)	Sixth Plan (1980-85) For the years 1981 and 1982.
I) Centre	-407.26	-918.0	-782.13	-763.97	-2047.0	-3655.7	-2433.2	-3969.2
II) State	- 39.54	-114.3	- 43.40	- 56.50	- 184.0	+ 774.2	- 187.5	-1917.5
Total (I+II)	446.8	1032.3	825.53	820.47	2231.0	2881.5	2620.7	5886.7

Sources : 1) Currency and Finance Reports for 1956-57, 1957-58, 1969-70 and 1982-83.

2) Reserve Bank of India Bulletins.

During the Second Five Year Plan period total deficit financing amounted to Rs. 1032.3 crores. Of the total amount Central Government financed deficit of Rs. 918.0 crores and State Governments deficit amounted to Rs. 114.3 crores. A large amount of deficit financing thus, was incurred during Second Five Year Plan.

Third Five Year Plan resorted to total deficit financing of Rs. 825.23 crores which was slightly less in amount than that of the Second Five Year Plan. In this plan Central Government's deficit was Rs. 782.13 crores and State Government's deficit was Rs. 43.40 crores.

The total deficit financing in three annual plans was Rs. 820.47 crores. Of which Central deficit accounted to Rs. 763.98 crores and State's deficit accounted to Rs. 56.60 crores.

In the Fourth Five Year Plan, deficite amounted to Rs. 2231.0 crores. The amounts of Central and State Government's deficit were Rs. 2047.0 crores and Rs. 184.0 crores respectively.

In Fifth Five Year Plan, deficit amounted to Rs. 2881.5 crores. Of which, Rs. 3655.7 crores and Rs.+774.2 crores were the deficit of Union and States.

One year plan of 1979-80, amounted deficit financing of Rs. 2620.7 crores, of which Rs. 2433.2 crores were of the Centre and remaining of by the States.

The total deficit financing in the first two years of the sixth five year plan was Rs. 5886.7 crores. Central and State Governments deficit were Rs. 3969.2 crores and Rs. 1917.5 crores respectively. Thus, the target of deficit financing of Rs. 5000 crores for Sixth Plan has been exceeded by actual deficit financing of only first two years of sixth plan.

Total Plan Expenditures and Deficit Financing Utilised in the Period 1951 to 1982 :

Now, it may be worth examining the retation between total plan expenditure and the total deficit financing utilised during the planning period. The data given in Table-II, represents these details.

In the First Five Year Plan, of the total plan outlay of Rs. 1960 crores in the public sector, 22.8% of the outlay was financed through deficit financing.

In the Second Five Year Plan period, out of the total plan outlay in public sector of Rs. 4600 crores, more than one-fifth, i.e. 22.4% of amount was raised through deficit financing.

These proportions declined from 9.6% to 12.4% in Third Plan and three annual plans. It again declined from 13.8% to 7.33% in fourth plan and fifth plan respectively.

TABLE-II

PLAN EXPENDITURE AND DEFICIT FINANCING (Utilised)@

(Rs. in Crores)

Item	First Plan 1951-56	Second Plan 1956-61	Third Plan 1961-66	Three Annual Plans 1967,68, 69.	Fourth Plan 1969-74	Fifth Plan 1974-79	Sixth Plan 1980-85
I) Total Plan Expenditure	1960	4600	8573	6626	16160	39303	97500*
II) Total Deficit Financing :							
a) Amount	446.8	1032.3	825.53	820.47	2231.0	2881.5	5886.7
b) Percentage of Item-I	(22.8)	(22.4)	(9.6)	(12.4)	(13.8)	(7.33)	(6.03) For the Year 1981 and 1982.

@ It is presumed that all deficit financing has been utilised for Plan purposes, although actually some amount of deficit financing is also used for non-plan purposes.

Source : Prepared from the Table No. I in Chapter-IV and I in Chapter-IX.

* Estimates.

Sixth Five Year Plan proposed to finance deficit of Rs. 5000 crores throughout the plan. But the data presented for the first two years indicates that the amount of Rs.5886.7 crores of these years exceeded to the proposed Rs. 5000 crores of the sixth plan period. Even the percentage ratio of deficit financing to total plan outlay came down to 6.03%.

It is thus evident from the data that first and second Five Year Plans followed the method of deficit financing in huge amount. However, the Government curtailed the amount of deficit financing from Third Five Year Plan. Again, it may be remarked that, the Government was unable to control the amount of deficit financing within the limits dictated by the growth of output in the economy. The result was that, it was the most important factor which caused inflationary pressure in the economy. It may be stated here that, to the largest extent deficit financing has been utilised for non-plan purposes, a very little amount of deficit financing is used for plan purposes.

Effect of Deficit Financing on Money Supply and Prices :

As already seen the deficit financing in the first plan was Rs. 446.8 crores. It was Rs. 1032.8 crores in the second plan. The amount of deficit financing was Rs. 825.53 crores and Rs. 820.47 crores in the third Five Year Plan and three annual plans respectively. Further it rose to Rs. 2231 crores in fourth plan, Rs. 2881.5 crores in fifth plan and Rs. 5886.7 crores in the sixth plan.

The effects of financing a budget deficit are seen mainly on money supply, income and prices. The direct and immediate effect of deficit financing, for whatever purpose it is resorted to, is an increase in the total money supply with the public.[3] Consequently it increases the prices of goods and services unless production expands rapidly.

The Table-III shows data on money supply with the public, and wholesale price index of selected years during the planning.period.

The table shows the money supply with the public during the selected years of the planning period. The total money supply with the public was Rs. 1979.49 crores in 1950-51. It increased to Rs. 2901.72 crores in 1961 and further to Rs. 7341.1 crores in 1971 and Rs. 28126 crores in 1983. The data represents that the total money supply with the public has increased rapidly during the planning period. The most striking effect of deficit, financing is on the general price level through expansion in money supply. Hence, the deficit financing tends to be inflationary.

As explained above, the rise in money supply, raises the prices of goods and services. Government, through deficit financing increases income of the public which tend to raise the prices and requires the suitable fiscal and monetary policy to countract inflationary effect. Table-III relating to wholesale price index shows the rise in price level throughout the planning period.

TABLE-III

EFFECTS OF DEFICIT FINANCING ON MONEY SUPPLY AND PRICES

(Rs. in Crores)

Item Year	Total money supply with the public (Rs. in crores)	Index of wholesale Prices
		(1939 = 100)
1951	1979.49	450
		(1953 = 100)
1956	2184.31	90.92
1961	2901.72	124.9
		(1970 = 100)
1971	7341.00	105.6
		(1971-= 100)
1981	24075	287.8

Sources : 1) Planning Commission, Second Plan, p.4.

2) R.B.I. Currency and Finance Report 1982-83, Vol. II, p. 5.

3) C.S.O. Estimates of N.I. Budget Papers.

4) Economic Times Statistical Survey of Indian Economy - 1982-83.

In the First Five Year Plan period, deficit financing did not have any adverse effect. In the First Plan the wholesale price index went down from 100 in 1952-53 to 90.92 in 1955-56, as a result of higher increase in output of goods and services.

But the deficit dose of Rs. 1032.3 crores in the Second Plan had positively inflationary effect. The wholesale price index (1952-53 = 100) shot up from 90.92 in 1955-56 to 124.9 in 1960-61.

In the Third Five Year plan, it was decided to reduce deficit financing to Rs. 550 crores, but actually it was Rs. 825.53 crores. The total deficit financing during the period from 1967 to 1974 was Rs. 3051.47 crores. Therefore, price level went on rising fast and stood at 308.9 (base 1961-62 = 100) in end June 1974.

During the period of fifth and sixth plan the Government resorted to deficit financing to the tune of Rs. 11388.9 crores (Table-II) i.e. for period from 1974 to 1981-82. With this huge amount of deficit finance the price index for all commodities (1970-71 = 100) moved up to 309.3 by the end of June 1983.[4] This shows that deficit financing definitely contributed to the inflation in India.

A backward economy needs additional money supply to affect positively output and employment. Further, money supply meets the demand for liquidity to finance day-to-day transactions and for unforseen contingencies. Again, increased money supply may keep economy in motion and will not prove inflationary. Thus, "From this point of view it is important to stress that the scope for deficit financing is intimately bound-up with the policy regarding the physical controls. If the supply and distribution of foodgrains, and other essential commodities, could be so organised as to meet the minimum requirements of the population, the danger of deficit financing to that extent be minimised."[5]

In conclusion, we may say that, "the expenditure needs for the speedy programme of investment is on a large scale and it is difficult to raise the required resources through normal sources of revenue. The measure of deficit financing is, therefore, utilised in the implementation of several development schemes."[6] Moreover, proper safeguards and measures are necessary to render the quantom of deficit financing non-inflationary. Deficit financing should be to the minimum warranted by the genuine monetary needs of the economy.[7] Increase in money supply takes place not only through deficit financing alone but also through credit creation by the banking system. Both these have to be viewed together. Their appropriate limits should be in the light of relative requirements which the economy can absorb in the aggregate. Deficit financing is necessary for further activation of the economy.[8] Within moderate limits deficit financing has a place in developmental plans.

R E F E R E N C E S

1) G.O.I., Planning Commission, First Five Year Plan, p.60.

2) R.B.I., Currency and Finance Report for 1957-58.

3) R.G. Kulkarni, "Deficit Financing and Economic Development," Asia Publishing House, Bombay, 1966, p. 33.

4) Currency and Finance Report, 1982-83, p.85.

5) G.O.I., Planning Commission Report of First Five Year Plan, p. 61.

6) R.G. Kulkarni, "Deficit Financing and Economic Development", 1966, p. 32.

7) G.O.I., Planning Commission - Third Five Year Plan, p. 99.

8) G.O.I., Planning Commission - Fourth Five Year Plan, p. 83.