CHAPTER - II :: DEFICIT FINANCING AN APPROACH ::

1) NATURE OF FISCAL OPERATIONS:

Deficit financing is chiefly a fiscal instrument. For a proper appreciation of the role of this device, whatever may be the purpose in view, it is necessary firstly to consider the nature of fiscal operations. In modern times public finance assumes growing importance in the economic life ofthe community. Fiscal operations involve firstly, transfer of purchasing power from people to the Government which comprises taxes, fees, and secondly, its retransfer to the people in the form of expenditure. The main business of the State is the satisfaction of collective wants.

PRINCIPLES OF FISCAL POLICY

J.B. Say remarked that, "The very best of all plans of finance is to spend little and the best of all taxes is that which is least in amount." But it is not true that every tax is an evil, nor it is that all public expenditure is good.

A complete judgement upon fiscal operations historically related to the principles of minimum activities of the State.

Dalton stated the fundamental principle of maximum Social Advantage. The best system of public finance is that which secures the maximum social advantage from the operations which it conducts. Prof. Pigou expressed it interms of optimum finance.

Evolution of Fiscal Policy

Adams Smith, the founder of classical school, laid down the foundation of the doctrine of "Laissez-fair". According to him economic equilibrium is attained by internal adjustments of the economy. Mr.Ricardo also laid importance tolaissez-faire. J.S. Mill, however, extended state action in production, distribution, exchange. All together stated that deficits lead to inflation and hence reduction in rate of progress.

Neo-classicals extended State action for the transference of income from rich to poor in the interest of socialwelfare. They based on the view that there eixst certain misdirections of resources, which ought to be corrected by fiscal devices. Keynes maintained that unemployment arises due to deficiency

of effective demand because of underconsumption and oversaving. Unemployment is the evil. So it should be mitigetted by extending government expenditure. These revolutionary ideas lead to wide extention of State action.

2) DEFICIT FINANCING - SOME GENERAL CONSIDERATIONS :

Until recent years, a budget was considered as surplus or deficit. Surplus budget is that in which revenue is more than expenditure. Deficit budget is one in which expenditure is more than revenue.

Though the government is making much efforts to raise revenue through taxation, borrowing and external finance, there may still remain a gap between receipts and expenditure, necessary for rapid economic development. The governments of underdeveloped country's may, therefore, have to adopt the device of deficit financing as a last resort.

What is Deficit Financing?

Deficit financing refers to the ways in which the budgetary gap is financed. The government resorts to this method of financing when it is unable to cover its total expenditure from normal sources of revenue,

such as taxation, fees, income from government properties and undertakings, proceeds of loans, small savings etc.

Public borrowings were not included in the receipts side but the proceeds of public loans utilised for bridging the gap between revenue and expenditure were considered as deficit spending or deficit financing. In modern times, however, borrowings from the general public are included in receipts of the government in its capital account and it even then there remains a gap between revenue and expenditure, the method of financing is referred as deficit financing. Thus, the term "Deficit" means there is wanting, falling short or excess of expenditure. If this wanting is satisfied by printing money then we say it as deficit financing.

The term deficit financing has been used in different senses.

a) **Western Approach:**

In western countries, it has referred to excess of expenditure by the Government, including capital expenditure, over revenue receipts even if it is covered by receipts obtained through loans. Thus, according to this definition, deficit financing means a

budget gap covered by loans i.e. from people, commercial banks and central bank. In this manner, it activises idle savings and increases total expenditure and output.

b) **Indian Approach:**

According to Indian budgetory documents governments borrowing from the public and the commercial banks is included in the receipts on capital account under the head of "market borrowings". Governments expenditure to the extent of its market borrowings does not result in an addition to the aggregate expenditure, which is implied in the meaning ofdeficit financing in India. In the First Five Year Plan of India the term deficit financing has been defined as "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 lies therefore, in Government spending in excess of the revenue it receives in the shape of taxes, earnings of State enterprises, loans from the public, deposits and funds and other miscellaneous sources. The Government may cover 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."

The significance of this modified concept of deficit financing accepted by the Government of India in borrowing from publicis not considered as a part of deficit financing. The reason for excluding it is that when the government borrows from public, it is argued that it takes away a part of purchasing power. Government's spending to the extent of its borrowing from public, therefore, does not result in a net addition to the aggregate expenditure and, therefore, it should be excluded from the concept of deficit financing. In this way deficit financing means addition to the aggregate expenditure.

Thus, the difference between two approaches is that deficit financing in western approach means financing deficits (expenditure incurred in excess of its current revenues) by borrowing. In the Indian sense it refers tofinancing by borrowing from Central Bank (i.e. creation of money) and reducing the governments cash balances.

According to J.I. Laliwala, "Deficit financing is the financing deliberrately created budget deficit by created money. It also mean a method

of financing the budget deficit." Thus, there are two characteristics of deficit financing - one is financing deficit and the other is financing done by the increase in money supply.

3) **Objectives of Deficit Financing:**

1. The main objective of deficit financing is to develop the economy into self-reliant economy.
2. To break the vicious circles of poverty and uplift economic conditions of the poor.
3. To have alround development of the economy.
4. Deficit financing has been resorted to for meeting the resources gap.
5. It has been resorted to for complete mobilisation of resources.
6. It has been resorted to achieve full employment.

4) **Methods of Deficit Financing:**

Mainly there are two methods of deficit financing. They are (a) borrowing from the Central Bank (i.e. creation of money) and (b) reducing government cash balances.

Reserve Bank provides credit to the government under three methods - (1) By providing loans and advances, (2) By purchasing the securities of the government, (3) By purchasing treasury bills. Under all these three methods it provides credit by creating new money. It is the main method of deficit financing.

The other method of deficit financing is reducing cash balances, meaning of deposits of the government with Reserve Bank or the cash balances of the treasury are withdrawn.

The following are the different methods of deficit financing listed out which include the above two methods.

i) Issue of Rupee notes and coins by the RBI.

ii) Issue of one rupee notes and small coins by the Treasury.

iii) Loans and advances by RBI to the government.

iv) Purchase of Treasury bills and securities by the Government.

v) Purchase of Treasury Bills and investment in government securities, commercial banks and State co-operative banks.

vi) Withdrawal of its own deposits by the government from the RBI.

vii) Withdrawal of its balances by the government from the Treasury.

5. Deficit Financing during Different Situations:

Deficit financing has been resorted to during three different situations in which objectives and impacts of deficit financing are quite different. These three situations are depression, war and economic development.

A) Deficit Financing During Depressions:

Monetary policy alone proved inadequate to restore prosperity during depression. Therefore, government gave importance to deficit financing. It was adopted in three forms like pump-priming, cyclical deficit spending and secular-deficit financing.

i) Pump Priming

This has been applied mainly to deficit financing resorted to as a means of promoting recovery after depression. Pump-priming policy means starting and executing public works, which primed money in the economy through spending of borrowed money, increased production. It is purely a temporary device which is used to start the stagnant wheels of economic activity. It will have desired effects only when there is

optimism in private investment projects continued. If private sector is unable to invest then there will be no limit of deficit financing.

ii) **Cyclical Deficit Financing:**

Deficit financing when resorted to, reduces intensity of the cycle is called cyclical deficit financing. It is undertaken by the government for offsetting fluctuations in private spending on investment.

iii) **Secular Deficit Financing:**

Prof. A.H. Hansen advocated secular deficit financing. He maintained that deficit financing was not simply a measure for mitigating the cycle, rather it must be undertaken to make up forsecular deficiency in investment. Therefore, he argued for permanent deficit financing.

B) **Deficit Financing During War:**

Deficit financing has its historicalorigin in war finance. For the effective prosecution of war, large financial resources are required. That is, every government has to spend more than its revenue receipts from taxes and borrowings. Tax can be increased but danger of disincentive effect is there. Therefore, deficitfinancing is only the source of raising the

finance for war. Inflation becomes more orless inevitable during war.

C) Deficit Financing for Economic Development:

The problem of economic development of underdeveloped countries is more important. The problem of economic development is raising of finance, here we devoted tothis problem, with special reference to the role of deficit financing in economic development.

6) PROBLEMS OF DEVELOPMENT IN UNDERDEVELOPED COUNTRIES:

Economic development is a process whereby the real nationalincome of an economy increases over a long period of time. Economic development means growth of output perhead of population. Diferent countries are in different stages of economic development, they may be classified as poor or rich, by comparing growth of population and percapita real income. The term underdeveloped countries refers to the countries with levels of real income and capita head of population which are low by standards of North America, Australia... etc. Nearly three-fourths of the world's population lives in underdeveloped countries. The rate ofgrowth of national income for every 10 years in rich

countries is 20 to 30% whereas in underdeveloped countries it is less than 15%.

Although there are several diversities among different underdeveloped countries (UDC's) we find certain generalcharacteristics which are common to all like primary producing, burdened with population pressures, economic backward population, capital deficiency, low effieiency of production, employment is misdirected, market imperfections etc.

More important than the obstacles of market imperfections is the alleged presence of "vicious circleof poverty and underdevelopment." Because of low level of real income and high level of propensity to consume, the flow of savings is small. Investment in capital goods is low on account of low savings and due to inadequate capital stock, the level of real income is low again. That means, a poor country is poor because it is poor. The vicious circle can be broken only by drastic national and international action.

7) **EXTENT AND TYPE OF INVESTMENT REQUIRED:**

After considering the factors responsible for the backwardness of these economies,we may now briefly consider how the development process can be initiated.

According to Mier and Baldwing,"The problem is much more one of dynamic utilisation of resources and structuralchanges rather than the fine adjustment of existing resources at the margin." As Schultz observes, "to achieve economic growth of major importance in such countries, it is necessary to allocate efforts and capital to do three things; increase in quantity of reproducible goods, improve quality of people and increase the level of productive arts." The removal of market imperfections is particularly necessary for rapid capital accumulation which is major requirement of growth. Unless the level of capital formation is sufficiently high, rapid economic development is difficult. For example,in the U.K. during 1870-1913, net investment was on an average more than 10% of national income and during prosperous years 15%. In USA during 1869-1913 it was 13 to 16%. In Japan too net investment was high i.e. 12% of national income, and it was increased to 17% during 1910-20. For the UDC's for economic development with low standard of living, rapid growth of population, 20% of national income must be the rate of investment. But it is only about 5%. "A rocket or moonship must attain a definitely established speed of rise before it can

escape from the earth's gravitational field and become a free moving austronomicalobject. Therefore, therate of investment be increased from 5% to 15% or 20%." For this there must be considerable increase in saving. The high level of saving may exist in countries which are already so well equipped with capital that the incentives to invest is low and there is a danger of shortage of investment opportunities. In UDC's, however, there is no such danger but the propensity to save is very low.

It is sometimes argued that the level of saving is to a greater extent depend on the level of national income. Higher the national income higher should be the proportion saved normally. However, this is not always true. In USA for instance, considering the rate of increase in percapita income and its high level of savings. In the beginning, the rate of saving during 1870 and 1913 15% was relatively low. On the other hand Japan, inspite of lower level of income attained a substantially high rate of investment out of its own resources.

Again, between 1878 and 1940, the price level rose by 400% in Japan, whereas it rose by less than 100% in USA. Thus increasing prices tended to enforce the rate of savings.

In UDC's both level of income and savings are very low which retard investment and capital formation. It is necessary, therefore, firstly to take steps for increasing saving and capital formation.

In earlier stages of development, as larger and larger resources can be gathered through the mobilisation of savings. And the resources can be used to develop transport, communications, irrigation and power etc. Later on there will be scope for utilising underutilised resources. By this process the so-called vicious circles may be broken, opening the way for rapid expansion.

But such voluntary savings are meagre compared with the need for large investment, that action becomes difficult. The private sector cannot wholly be relied upon to undertake the tasks of development and a high rate of investment cannot be attained by functioning of free market forces. A more vigrous governmental action, therefore, is necessary.

Different views have been expressed about the sequence and tempo of development. Broadly, there are two different schools of thought. According to one group, the obstacles to development can be overcome only by deliberate and immediate industrialisation

through state interference. The government should engage in comprehensive programming and planning and attempt to achieve a high rate of capital formation as soon as possible. A complete development of paln is advocated.

The second group advocates a more gradual approach which places little emphasis on deliberate industrialisation. It approaches development problems in step by step fashion. Those who oppose gradualist approach maintain that unless the action involves big changes the development process will not be able to become self-generating and cumulative. This view has been expressed in terms of a "critical minimum effort thesis" of development.

It is also, during last few years that we observe a severe attack on"gradualism". Therefore, critical minimum effort or big push is needed to move towards high level of productivity and income.

As we discussed already there are different sources of financing economic development such as taxation, borrowing,savings. But with these sources of finance for economic development will not be available sufficiently. Therefore, deficit financing is an important sources of financing economic development in

a developing country. It has been considered as means of achieving full employment.

In this situation, many economists have given the idea of accelerating economic growth by deficit financing which would facilitates in reducing unemployment by transfer of disguised unemployed from agriculture to productive work i.e. construction of social overheads. Deficit financing leads to inflation in developing countries. Therefore, it is considered as an inflationary method of financing investment expenditure. Again the view that deficit financing is always inflationary during the process of economic development is unacceptable and unwarranted in all circumstances. We may now, therefore, consider the problem as to whether deficit financing is always and necessarily inflationary and whether it is helpful in the process of economic development.

8) IS DEFICIT FINANCING NECESSARILY INFLATIONARY?

The deficit financing for capital formation is inflationary. The newly created money is spent for the creation of capitalgoods, but capital formation is a time-consuming process. During the period of capitalformation, purchasing power in the hands of the

people increases but the supply of consumer goods does not expand correspondingly. Therefore, the price of these goods tend to rise and if this trend is unchecked, inflationary pressures may spread over toother sectors of the economy. Capital formation through deficit financing is likely to generate inflation because the propensity to consume is high, there are many market imperfections, there is little excess capoacity in plant and elasticities, of food supply are low. It is also argued that UDC's are more prone to inflation than are the developed countries.

Danger of Inflation:

When deficit financing is inflationary it will go against the very purpose for which it is used because it willsimply lead to continuous inflation and development. Inflation creates uncertainty, labour unrest, work stoppages and decline in production, demand for higher wages and salaries to compensate for higher cost of living. Income distribution effects of inflation are also objectionable. Inflation reduces the realincome and the real consumption of all except rich. It is a sort of tax on incomes. It leads to balance of payments difficulties because country loses export market due to increase in prices.

It is distorting the pattern of investment and production. It transfers resources into less urgent and speculative fields, where the scope for profits to private sector is more.

It increases administrative expenditure of the Government by sanctioning dearness allowance, price controls distribution of essentials through fair price shops etc.

All this shows deficit financing is inflationary and destroys its own purpose of aiding economic development.

Non-inflationary Impact:

It is, however not correct to say that deficit financing is necessarily and always inflationary. Under certain circumstances properly managed deficit will not only be non-inflationary but also contribute towards attaining high level of economic activities. In this situation many economists have given the idea of accelerating economic growth by deficit financing which would facilitate (reduce under economic) transfer of disguised unemployed from agriculture into productive work i.e. in construction of SOC. They also argue that this type of deficit financing may be persued without serious long term

consequences since inflation which it will be self-defeating.

The IMF mission in its report of the Government of India also observes in this connection that, "so long as the expansion of money supply is no more than enough to finance the larger volume of production, consumption and investment at stable prices, it is not only non-inflationary but is essential to the proper functioning of economy." Thus, deficit financing may be of more constructive use in a backward economy.

It may also be contended that even if deficit financing tends to be inflationary, it need not be condemned in all circumstances. Thus, if deficit financing results in a mild inflationary situation which may afford incentives because when the capital projects are completed they will add to the output of agriculture and other consumer goods to certain sectors of the economy to draw into the use of unutilised resources, then that degree of inflation may be regarded as functional inflation. It is harmless. In other words, increase in prices required for attracting resources is called functional inflation.

Usefulness of Inflation:

Inflationary impact of deficit financing is helpful for economic development to a certain extent and under certain circumstances.

1) Underdeveloped countries with their low income, low savings, inadequate investment can develop only with powerful stimulus of inflation.

2) Inflation stimulates economic activities in which manufacturers and the traders may make high profits. If the profit is ploughed back then there will be possibility of rapid economic development.

3) Inflation leads to a increase in savings. Rising prices reduce consumption and increase savings.

4) Rising prices alsoresults in reducing unemployment.

Although inflation has many benefits, but before adopting deficit financing for economic development in UDC's or developing countries, the first consideration is to assertain whether there are already any inflationary forces. If the economy is already under the grip of inflation deficitfinancing can only add to the problem. But if the economy is without such

pressures, it can absorb additionaldoses of newly created currency and it can stimulate the expansion of productive sectors.

For the sound credit policy, the amount of such financing must be limited and created money must be spent on the quick resulting enterprises. If the projects in which investment is made require a long time to complete (for example, construction of heavy industries, multipurpose river valley projects) or if such investments increases capacity of community only indirectly (i.e. construction of schools, colleges, housing) their effect on output will gradual and there may not be immediately any appreciable decrease in prices. But if newly created money is spent on the quick resulting enterprises (i.e. small scale industries, minor irrigation schemes) which require few months to build and which cost very "little". The output increases within short-time and there will be inflationary impact. That is why J.M. Keynes refused long-run of classicals and assumed short-run.

9) **CONCEPT OF SAFE LIMIT:**

Deficit financing can promote capital formation and economic development and should be tolerated to that extent only. This extent of

tolerance is called the "Safe Limit" of deficit financing. This safe limit shows the amount of deficit financing that the economy can absorb and beyond which inflationary forces may be set in motion. This safe limit is reached when the economy passes from mild inflation to spiral inflation. It is not possible to identify the exact quantity of deficit financing. It can be possible to identify it by the factors that affect it.

If the demand for and supply of money is balanced then that is the point of determining safe limit of deficit financing. If the demand for money is low in the economy the safe limit of deficit financing will be low and deficit financing must be kept at low levels otherwise it leads to inflation. On the other hand if the demand for money is high thesafge limit of deficit financing will also be high and large amount of deficit financing will not be inflationary.

If the supply of money in the economy is high the safe limit will be low and if supply of money is low safe limit will be high.

10) **CONCLUSIONS:**

Underdeveloped countries require large amount of money for economic development but the resources are

scarce. Therefore, it has to resort to deficit financing (or creation of money). Deficit in threse countries is inflationary. However, it is inevitable as a source of finance for investment purposes. The moderate inflation will not have evil consequences. It may be useful for stimulating economic development. Like other measures of public finance, deficit financing has certain effects on economic life but, they depend on the stage of economic development and prevailing circumstances. If it is adopted safely there will be no evil effects in all stages of development. This must be used to finance not the unproductive activities but the productive activities. The finance made by deficit must be in quick yielding projects.