Deficit Financing

Deficit financing is practised whenever government expenditure exceeds government receipts from the public such as taxes, fees, and borrowings from the public. Such an excess of government expenditure can be financed either by drawing down the cash balances of the government or by borrowing from the central bank.

Two Aspects of Deficit Financing

Deficit financing as an income generating expenditure has two aspects:

1. **Pump priming:** Pump priming means the power of deficit financing in stimulating private investment through giving small doses of investment in the economy.
2. **Compensatory spending:** Compensatory spending means that deficit financing can be used for compensating and neutralising tendencies towards over-saving and under-investment.

Deficit Financing and Deficit Budgeting

1. Deficit budgeting refers to the situation when current expenditure exceeds current revenue. In this situation no item on capital account is taken into consideration.
2. On the other hand, when we take into consideration not only current receipts but also receipts on capital account, e.g., public borrowing, and the gap between receipts and expenditure is covered by deficit financing.

Uses of Deficit Financing

1. **For prosecuting a war:** During the state of war, the government has to finance the purchase of arms and ammunitions through deficit financing. Deficit financing during war is very injurious for the economy. Private investments and savings are at their worst level.

2. **For fighting depression:** Deficit financing can be really helpful for the government during the period of depression. It can stimulate private consumption and investment. The government can increase its own expenditure on public works programme. The government's tax revenue remains constant but its expenditure has gone up, therefore, the deficit has to be met by borrowings. In this case, as government investment rises, the level of national income and employment also increases by more than the proportionate increase in government investment. Deficit financing can be used to create additional employment, when the economy is suffering from a deficiency of effective demand.

3. **For financing economic development:** The economic problems faced by underdeveloped countries are different from that of advanced countries. In advanced countries, the task of capital formation is in the hands of private entrepreneurs but in poor countries there is a dearth of people willing and able to undertake entrepreneurial functions. Therefore, it is the government's responsibility to boost up investment in public sector, generate revenue from it

and encourage people to save and invest. But, in a country, where a majority of people are living at the subsistence level, the margin between income and consumption is very low so that the voluntary savings cannot provide sufficient resources for development. The government may attempt to increase the volume of resources by additional taxes. Because of extreme poverty of the great mass of the people, additional taxation beyond a point raises problems, both economical and political.

Consequences of Deficit Financing

1. Increase in the money supply with the public
2. Rise in the level of income, and
3. Rise in the general price level.

Deficit Financing and Inflation

The inflationary implications of deficit-financing is divided into two parts:

1. Inflation in a full-employment economy, and
2. Inflation in an under-developed country or less than full-employment economy.

1. The first part is related to the inflationary impacts of deficit financing in a full employment economy. In this regard some writers hold the view that even under the conditions of full employment, in the long run, there is no problem of inflation, particularly in economically advanced countries. However, infact, at full employment a further increase in aggregate demand through deficit financing results in raising the general price level instead of adding to aggregate output and employment.

2. In the second part, there are five reasons by which the deficit financing results into inflation:

    (a) When there is a variety of channels into which increased money supply can flow
    (b) Non-homogeneity in skills or efficiency
    (c) Supply of resources is perfectly inelastic
    (d) Increase in wage rates
    (e) Increasing marginal cost

Precautions in the Use of Deficit Financing

1. Deficit financing should be used in moderate doses
2. Constant watch on price index
3. Prices of consumer goods and essential raw materials should be effectively controlled
4. Ensure a corresponding increase in the availability of goods
5. Concentrate on quick yielding projects
6. In order to keep down the prices of food grains, food imports should be arranged well in time and in adequate quantities.

7. Rise in wages and salaries should be checked lest the country be caught in a vicious circle of poverty
8. Excess money supply should be mapped up through taxation and borrowings
9. Ensure clean and efficient administrative system tackling the difficult economic situation with whole hearted cooperation from the people

Measures to Minimise Inflationary Pressure of Deficit Financing

1. Proper disinflationary fiscal policy,
2. Restrictive monetary policy to control non-essential private investment,
3. Economic controls through selective credit control, physical and fiscal controls, in order to influence the behaviour of private investment and channelise it into desirable lines,
4. Proper allocation of resources with major focus on agriculture and small and medium scale industries, and
5. Developing import surpluses for increasing the supply of goods.

Anti-Inflationary Fiscal Policy

Fiscal policy with respect to inflation includes all the measures of a monetary nature which the executive branch of the government adopts in connection with:

(a) Government spending
(b) Taxes, and
(c) Public borrowing

Fiscal policy has come to be recognised as the potentially most powerful instrument of economic stabilisation.

(a) Government spending: During inflation the government is supposed to decrease its own spending to counteract an increase in private spending. The government must simultaneously reduce expenditures and increase revenues to achieve a cash surplus to be used in an anti-inflationary manner.

(b) Taxes: It is axiomatic that during inflation the existing tax structure should be retained, that tax cuts should be resisted, and the new taxes should be adopted or tax rates increased, if possible – to reduce the amount of spendable money in the hands of general public. But care must be taken not to deflate the money incomes of the country via taxation so much as to provoke a recession of economic activity.

(c) Savings: Saving is a type of public borrowing which has a deflationary effect on the money supply and effective demand. The most effective anti-inflationary public borrowing takes the form of compulsory saving.

(d) Debt Management: Public debt may be managed in such a way as to reduce the money supply or to prevent further credit expansion. Anti-inflation debt management often refers to the retirement of bank-hold debt out of a budgetary surplus. It includes the retirement of public debts of the following categories:

(i) Retirement of public debt by central banks out of a budgetary surplus is most deflationary
(ii) Retirement of bank-held debt (i.e., commercial banks) is neutral in its effects
(iii) Retirement of a maturing portion of debt held by the non-bank public, which has also neutral effect.

(e) Gold Sterilisation: Whenever the gold inflow is deemed too dangerously inflationary in effect, the government may decide to sterilise gold in order to keep bank reserves from increasing gold acquisitions.

(f) Overvaluation: In order to control domestic inflation, a country might maintain the overvalued exchange value of its currency, that is, an expensive currency relative to foreign currency. An overvalued currency is anti-inflationary in effect for three reasons, namely:

(i) Because of its discouraging effect on exports and decreasing effect on domestic money incomes
(ii) Because of its encouraging effect on imports and increasing effect on import expenditure
(iii) Because of its cheapening effect on the price of those foreign materials which enter into the domestic cost of product of its preventive effect on the upward-cost price spiral.

Concepts and Principles of Federal Finance

Federal finance seeks to maximise total welfare. The economic welfare in an under-developed region in a federation can be increased by the diversion of resources from the developed regions.

The general principle to maximise economic welfare is that each regional or state government should try to equate marginal social benefit (MSB) with marginal social cost (MSC). The federal government will try to do so for the whole country. Thus the principle of federal finance would be:

MSBa = MSBb = MSBc = ……
MSCa = MSCb = MSCc = ……

Equalising of MSB and MSC would require a substantial inter-area transfer of resources in a federation for achieving what Professor Buchanan calls 'inter-personal equity'. Inter-personal equity means equal treatment to equals. A transfer of resources is necessary to achieve 'horizontal equity'. If the same amount of expenditure were made in all states, it would mean that the rich state would be subject to less tax than his equal income counter-part in the poor state.

The principles of federal finance are listed below:

1. No discrimination in levying taxes among the states. It implies uniformity of taxation.
2. Independence of federal finance to impose taxes and spend.
3. Central government and the federal units have no dependency on each other and should carry their functions normally
4. Resources should be capable of expansion as the requirements increase.
5. Efficient economy, i.e., minimum tax evasion, effective tax collecting system, minimum cost of tax collection, minimised adverse effects on trade and industry, etc.
6. Provision for grants-in-aid to meet resource deficits.