Chapter - 6

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In recent years, deficits in the budget of the Central Government of India have become a key-concern in the making of economic policy. Containing the deficits constitutes one of the top priorities of the government in the management of the economy. If however, the deficits are to be kept within reasonable limits, there must be an efficient system of monitoring so that appropriate action can be taken in time whenever there are indications that the gap between expenditures and receipts of the government is likely to go beyond the reasonable limit. High levels of fiscal deficit relative to GDP tend not only to cause sharp increases in the debt-GDP ratio, but also adversely affect savings and investment, and consequently growth.

For quite some time now, there has been a fierce debate among economists as to the justifiability of dependence on deficit as a tool of economic development. Policymakers are often seen to follow a path of contractionary fiscal policy, more so after the implementation of the FRBMA. At present, there is an intense debate among the economists
as to the relevance of the deficit-cutting strategy as, there is, by
definition, a tension between fiscal restraint and finding resources for
all the expenditure needs of the government.

In the light of this debate, it will be useful to see the effect that is
exerted by fiscal deficit on some significant macroeconomic variables
like rate of economic development, inflation, public debt and trade
deficit etc. This is what this study seeks to accomplish. This study has
devoted a complete chapter to analysing the effect of fiscal deficit on
each of the above mentioned variable. Thus this study is a small
modest effort to reckon the impact of one of the most widely discussed
macroeconomic indicator of economic health of an economy – the
fiscal deficit – on selected macroeconomic variables of Indian
Economy. Following is a brief abstract of chapters of the study.

Chapter 1 introduces the problem under study. It begins with defining
the key concepts like fiscal deficit, revenue deficit, and primary
deficit. Then it gives theoretical perspectives in terms of neo-classical
view, Ricardian view and the Keynesian view regarding usefulness of
fiscal deficit. It begins with FRBMA and underlines the possible
problems underlying FRBMA. Economists are divided in their views on whether to go for an expansionary or contractionary fiscal policy. Emphasis on fiscal deficit reduction without paying attention to its quality may lead to the centre and the states resorting to a softer option of cutting productive capital and necessary maintenance and social sector expenditure. In the event of inability to garner the required revenue rates, the FRL targets might be met by imposing cuts on both capital and social sector expenditure. This is likely to have adverse consequences on equitable growth. Insufficient capital expenditures might contribute to the infrastructure gap. To analyse the relevance of this all, it is important to estimate how fiscal deficit is affecting key macroeconomic variables in context of the Indian Economy. Thus the first chapter introduces the problem or theme of the study. This chapter also lays down the research methodology.

Second chapter attempts to establish a relationship, if any, between the fiscal deficit and rate of inflation. It discusses inflation in detail and various concepts related with it. Impact of many determinants of inflation has been examined along with fiscal deficit. The results have
been derived with the help of tables, time series graphs and regression analyses. Far from expectations, money supply does not seem to influence general price levels in India significantly. To make the analysis more reliable, a separate regression was run to check the effect of excess money supply growth on inflation rate but it was also found to be ineffective. Similarly exchange rate has also been analysed and it was seen that in Indian economic scenario, exchange rate did affect inflation rate significantly and the relation between the two was found to be an adverse one. According to the model developed in this chapter, fiscal deficit shows a negative impact on rate of inflation in the economy at an insignificant level while it shows a positive impact of increase in money supply and appreciation in exchange rate on inflation.

The third chapter deals with an extremely relevant issue, namely, the impact of fiscal deficit on economic development. It is very important to see whether constraining fiscal deficit would be good or harmful for economic development of the country. According to theory, if government spending and investment are efficient and beneficial for
socio-economic development, then fiscal expansion will be good for the economy. Another generally held view is that fiscal austerity could be beneficial for socio-economic development, for economic growth and stability and thus ultimately for welfare. We tried to check the impact of fiscal deficit by taking some variables assumed to be relevant for determining economic development, like rate of economic growth, poverty ratio, unemployment rate and change in share of secondary sector and tertiary sector in national income of the economy.

Though the Indian Economy has so far escaped all the dangers associated with huge government deficits, it is argued that the picture of Indian economy could have been even brighter, had the state of our finances not been so bad. We have conducted a regression analysis taking Growth rate of GDP as the dependent variable and Combined Gross Fiscal Deficit, Net Domestic Capital formation measured as percentage of GDP and composite infrastructure index as the explanatory variables. The empirical results also show that high fiscal deficits can cause rate of economic development to slow down.
Chapter 4 analyses the impact of fiscal deficit on public debt. The impact of fiscal deficit on debt seems to be an apt area of research as debt crises have been making headlines in the US and throughout Europe recently. Several financial crises in the past decade in large emerging markets were triggered by public debt. It is an important area of research also because according to the UNDP, some countries spend a greater proportion of their budget on debt repayment than what they allocate to education, health and other social services. In this chapter, we have not only analysed impact of fiscal deficit on the build up of public debt, but also discussed some related relevant concepts like solvency of the public sector, sustainability of debt and financing of fiscal deficit by alternative channels and their relative merits as well as demerits. The practices undertaken to control debt and deficits like FRBMA, the Maastricht Treaty norms and the Golden Rule of UK have also been discussed along with their consequent merits and demerits. Effect on fiscal deficit on debt via interest rate was also analysed. A regression analysis was conducted taking interest rate, gross fiscal deficit, rate of economic growth, Tax-GDP ratio and inflation as dependent variables. The models showed considerable
dependence of public debt on effective rate of interest. The model showed growth rate also to affect public debt positively, though at an insignificant level. It also demonstrated that in India, debt has been rising despite increase in tax-GDP ratio. The regression conducted shows clearly that fiscal deficit does cause public debt to rise significantly.

Chapter 5 analyses the impact of fiscal deficit on foreign trade. In particular, it investigates the cause-and-effect relationship between fiscal deficit and trade deficit. The simultaneous occurrence of fiscal deficit and trade deficit is known as twin deficits in economic literature. This chapter makes an attempt to see whether there is presence of this twin deficits phenomenon in context of the Indian Economy or not. To check this, a regression was run taking gross fiscal deficit taken of centre as well as states, rate of change in money supply, rate of change in foreign exchange reserves with the RBI, WPI inflation rate, rate of change in exchange rate taken to be the average of the financial year, and investment rate as the independent explanatory variables affecting Trade Deficit. The results indicate a weak negative effect of fiscal deficit on trade deficit at an insignificant level.
The sixth and the last chapter summarises the whole study consisting of all the variables on which the impact of fiscal deficit has been analysed in the context of the Indian Economy.

**Policy Implications**

The analysis shows that a higher fiscal deficit leads to lower economic development, higher public debt, higher trade deficit and lower rate of economic development. This indeed underlines the need to restrain fiscal deficit and follow the FRBMA targets religiously. However, care must be taken that to achieve lower rate of fiscal deficit, developmental capital and social expenditure do not become soft targets while ignoring revenue deficit. The path to fiscal correction must pass through correction in revenue deficit and tapping revenue sources.