IMPACT OF BUDGET DEFICIT ONTHE ECONOMIC GROWTH OF INDIA

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Abstract
Budget deficit is a debating word in developing countries; it maintains a relationship with economic growth of countries in different aspects. The objective of this study was to test the dynamic relationship between the budget deficit and the economic growth of India. The budget deficit issue has attracted a great deal of attention over the past two decades, as reflected in substantial in the academic literature and in the policy making community. Moreover, the budget deficit and related issues has become a major problem facing the Indian economy. Many economists have studied the relationship between budget deficit, and economic growth in both India. They have used various econometric models to estimate the relationship between budget deficit and economic growth. There are two group studies, in first group, budget deficit variable is directly entered into the model and the relationship with inflation has been studied, second group has indirectly studied the relationship between budget deficit and inflation. This study has also directly studied the relationship between budget deficit and economic growth. This study examine the impact of budget deficit on economic growth in india during the period from 1995-2016.
Keywords: Budget deficit; Economic growth; India and Inflation.

Introduction

Planning is an important factor of success in any field and in any organization. In the success or failure of any organization, the planning of economic activities plays a key role. Efficient planning brings success, no matter if this planning is for a single organization or for a whole country. This planning when financial is called budget. Budget is very useful in helping to set developmental and constructive policies for the country. When the spending of the government beats its revenues, it is called budget deficit. Economic trends affect the growth or reduction of fiscal deficits in many ways. Growth of the economy is measured as the percentage addition in GDP. Economic growth increases the production of goods in the country and increases its wealth. The quality of lives of a country's people will be higher when its economy is growth is higher. The country's policies play a Planning is an important factor of success in any field and in any organization. In the success or failure of any organization, the planning of economic activities plays a key role. Efficient planning brings success, no matter if this planning is for a single organization or for a whole country. This planning when financial is called budget. Budget is very useful in helping to set developmental and constructive policies for the country. When the spending of the government beats its revenues, it is called budget deficit. Economic trends affect the growth or reduction of fiscal deficits in many ways. Growth of the economy is measured as the percentage addition in GDP. Economic growth increases the production of goods in the country and increases its wealth. The quality of lives of a country's people will be higher when its economy is growth is higher. The country's policies play a major role in its production

Government expenditure on goods and services and resources mobilized by it through taxes, etc., are important factors that determine aggregate demand in the economy. When there is a deficit in the budget of the government, it spends more than it collects resources through taxes and non-tax revenue. In recent years there

have been huge fiscal deficits in India which have created large excess demand in the economy. This has resulted in inflation or sharp rise in the general level in prices. The deficit may occur either in the revenue budget or capital budget or in both taken together.

When there is an overall budget deficit of the Government, it has to be financed by either borrowing from the market or from the Reserve Bank of India which is the nationalized central bank of the country. RBI has the power to create new money, that is, to issue new notes. Thus, to finance its fiscal deficit, the government may borrow from Reserve Bank of India against its own securities.

This is only a technical way of creating new money because the government has to pay neither the rate of interest nor the original amount when it borrows from the Reserve Bank of India against its own securities. It is thus clear that fiscal deficit implies that government incurs more expenditure on goods and services than its normal receipts from taxes and non-tax revenue.

This excess expenditure by the government is financed by either borrowing from the market or by newly created money which leads to the rise in incomes of the people. This causes the aggregate demand of the community to rise to a greater extent than the actual amount of deficit financing undertaken through the operation of what Keynes called income multiplier. In the opinion of many economists, the expansion in money supply caused by monetisation of fiscal deficit leads to the excess aggregate demand in the economy, especially when aggregate supply of output is inelastic. The excess aggregate demand causes rise in the price level or brings about inflation in the economy.

Traditionalists claim that increase in budget deficit is harmful for a country. While the ricardians claim that debt do not harm the economy. A wide and huge budget deficit is one of the major economic issues of India and this budget deficit further causes many problems like low growth, high inflation and less investment. India is facing current account deficit from the last fifty years and this deficit is financed through international loans which caused indefensible international debt. For long run economic growth, balanced budget is required. If a country is facing the issue of budget deficit it means that the level of public saving is negative which is harmful for economic growth. Economic growth is determined by factors such as labor, capital, natural resources etc. Some economists think that budget deficit helps in the growth of the economy if it is due to productive expenditures like expenditures on education, health etc. whereas other economists state that budget deficit is harmful for the growth. They agree with neo-classical economies.

Increased budget deficit gives rise to macro-economic problems. These problems are:

- Increased level of inflation
- Increased debts in the economy
- Deficit of current account
- Reduced economic growth

Definition:

A budget deficit is when spending exceeds income. The term usually applies to governments, although individuals, companies, and other organizations can run deficits.

There are immediate penalties for most organizations that run persistent deficits. If an individual or family does so, their creditors came for calling. As the bills go unpaid, their credit score plummets. That makes new credit more expensive. Eventually, they may declare bankruptcy. The same applies to companies who have ongoing budget deficits. Their bond rating falls. When that happens, they have to pay higher interest to get any loans at all.

Governments are different. They receive income from taxes. Their expenses benefit the people who pay the taxes. Government leaders retain popular support by providing services. If they want to continue being elected, they want to spend as much as possible.

How Is the Deficit Financed?

The deficit is financed by government bonds. Most creditors think that the government is highly likely to repay its creditors. That makes government bonds more attractive than riskier corporate bonds. As a result, government interest rates remain relatively low. That allows governments to keep running deficits for years.

The United States finances its deficit with Treasury bills, notes, and bonds. That's the

government's way of printing money. It is creating more credit denominated in that country's currency. Over time, it lowers the value of that country's currency. That's because, as bonds flood the market, the supply outweighs the demand.Many countries, including the United States, are able to print their own currency. As bills come due, they simply create more credit and pay it off. That lowers the value of the currency as the money supply increases. But, if the deficit is moderate, it doesn't hurt the economy. In fact, it can boost economic growth. That's because government spending is a component of a nation's total output, known as Gross Domestic Product (GDP).

The United States benefits from its unique position. The dollar is a global currency. That means it's used for most international transactions. For example, almost all oil contracts are priced in dollars. As a result, the United States can safely run a larger debt than any other country. The consequences aren't immediate. Creditors are satisfied because they know they will get paid. Elected officials keep promising constituents more benefits, services, and tax cuts. Telling them they will get less from the government would be political suicide.

Budget Deficit History

For most of U.S. history, the deficit remained below 3 percent of GDP. It exceeded that ratio to finance wars and during recessions. Once the wars and recessions ended, the deficit-to-GDP ratio returned to typical levels.

The Deficit and the Debt

Each year the deficit adds to a country's sovereign debt. As the debt grows, it increases the deficit in two ways. First, the interest on the debt must be paid each year. This increases spending while not providing any benefits. If the interest payments get high enough, it creates a drag on economic growth, as those funds could have been used to stimulate the economy.

Second, higher debt levels can make it more difficult for the government to raise funds. As the debt to GDP ratio is 77 percent or higher, creditors become concerned about a country's ability to repay its debt. When this happens, they demand higher interest rates rise to provide a greater return on this higher risk. That increases the deficit each year. It becomes a self-defeating loop, as countries go deeper into debt to repay their debt. At some tipping point, interest rates on new debt can skyrocket as it becomes ever more expensive for countries to roll over debt. If it continues, long enough, a country may default. That's what caused the Greece debt crisis in 2009. The United States is different. During the 2008 financial crisis, the dollar's value strengthened by 22 percent when compared to the euro. That's because the dollar is a safe haven for investors. The dollar rose again in 2010 as a result of the euro zone debt crisis. As the dollar's value rises, interest rates fall. That's why U.S. legislators didn't have to worry about rising Treasury note yields, even as the debt doubled. In 2016, interest rates began rising. That will make the interest on the national debt double in four years. The Treasury must pay this interest or suffer the consequences of a debt default.

Review of literature

As already mention in the introduction part, there are number of empirical studies on the topic of the relationship among the budget deficit and economic growth. These studies clearly discuss in this part

S.I. Al- Khedair studied the relationship between the budget deficit and key macroeconomic variables of the major industrials countries. In this study the time series data were used and multiple regression method was employed to test the relationship between the dependent and independent variables. This study found that the budget deficit had negative relations with trade balance and positive associations with economic growth of the industrials countries.

G. Fatima, M. Ahamed, W. Rehman, prepared a research to find out the effects of budget deficit on economic growth of Pakistan. To test this objective, this study utilized the time series data from the period of 1978 to 2009 and employed the multivariate equation including the following variables: gross domestic product, inflation, real exchange rate, real interest rate, budget deficit, and gross investment. Here, the gross domestic product was treated as dependent variable and other variables were considered as independent variables. Meanwhile, this model was constructed based on the Ordinary Least Squares method. Finally, this study found that the budget deficit had negative relationship on economic growth of Pakistan during the sample period.

N. Ahmad studied the role of budget deficit in the economic growth of Pakistan using the time

series annual data from the period of 1971 to 2007. In this study the gross domestic product of Pakistan was considered as dependent variable and the budget deficit and foreign direct investment were used as independent variables. In the meantime the Augmented Dickey Fuller test was employed to test the stationarity of the variables and the Granger Causality Test was used to test the causality between the variables. At last, this study concluded that the budget deficit had maintained positive insignificant relationship on the economic growth of Pakistan and there was bi- directional causality relationship between the variables.

N. H. A. Rahaman investigated the relationship between budget deficit and economic growth based on the Malaysia's perspective using ARDL approach. To test the relationship this study used the quarterly data from 2000 to 2011 and considered four variables including dependent variables: growth of real gross domestic product, growth of federal government's debt, growth of productive expenditure and growth of non – productive expenditure. Here, the growth of real gross domestic product was deemed as dependent variable and other variables were reflected as independent variables.

G. Fatima, A.M. Ahmed, W.U. Rehman investigated the impact of fiscal deficit on investment and GDP growth of Pakistan. In this study the time series data were used during the period of 1980 to2009 and the simultaneous equation model was used to attain the objective. The two – stage least squares method was used to estimate the simultaneous equation models. In this study the GDP per capita income, exports, imports, fiscal deficit, interest rate, inflation, and population growth were used to explore the impact of budget deficit on investment and economic growth of Pakistan separately. Eventually, this study concluded that the budget deficit had impacted positive and significantly on economic growth and investment of Pakistan.

G.E. Edame, O.B. Okoi studied the fiscal deficit and economic growth of Nigeria using the Chow testing approach. In this study, the annual time series data were used from 1986 to 2013 and four variables were used such as gross domestic product, Fiscal deficit, interest rate, gross fixed capital formation. To test the objective of this study, the Chow endogenous break test, unit root test and co-integration test were utilized. Finally this study found that the budget deficit of Nigeria significantly impacted on economic growth.

Based on the above literature, most of the researches were made to test the impact of budget deficit on economic growth. But any of them did not investigate the dynamic relationship between the budget deficit and economic growth. Especially in Sri Lankan experience there was no research done properly in similar to the dynamic relationship among the budget deficit and economic growth. Therefore, this research gap will be reached through this study.

Post Liberalisation, 1990-91 till FRBM Act, 2002-03

By 1990-91 the Indian economy was quite weak; it was burdened with heavy debt rising interest costs and deficits. India traditionally had a current account deficit with significant portion of the imports being that of oil and petroleum products. The weak economic situation further worsened with the Gulf-war which led to rise in oil prices coupled with drying up of credit lines and investors pulling out money. The country's foreign exchange reserves had depleted significantly and the level of reserves was only sufficient to finance imports of another three weeks. India had to arrange for emergency funds from the IMF to avoid default on external obligations. In response to the crisis the government headed by Prime Minister Narasimha Rao commenced on the path of economic liberalisation whereby the economy was opened up to foreign investment and trade, the private sector was encouraged and the system of quotas and licenses were dismantled. Fiscal policy was reoriented to cohere with these changes. In order to augment the receipts the government undertook to reform both the direct and indirect taxes and for the first time the country embarked on the policy of disinvestment.

The measures proposed above to meet the crisis are often referred to as the New Economic Policy of 1991. These measures could broadly be classified under three heads viz. liberalisation, privatisation and globalisation.

Under liberalisation many industries were freed from the licensing requirement, the investment limit in small scale industries was enhanced, free determination of interest rates by commercial banks and abolition of restrictive trade practices. With privatisation, the government invited the private sector to own and manage part of Public Sector Enterprises and among the measures for globalisation included reducing tariffs, partial convertibility of the currency and increasing limits of foreign investment in India.

In addition to the above, the governments also brought in reform in the tax structure and reduce the non capital expenditure like subsidies. The reforms were calibrated to bring about revenue neutrality in the short term and to enhance revenue productivity of the tax system in the medium and long term. The overall thrust was to decrease the share of trade taxes in total tax revenue, increase the share of domestic consumption taxes by transforming the domestic excises into a VAT, and increase the relative contribution of direct taxes. The share of direct taxes as part of total revenue receipts rose from 15% in 1991-92 to 20% in 1996-97 and to 26% in 2000-01, correspondingly the share of indirect taxes fell from 61% in 1991-92 to 54% in 1996-97 and to 45% in 2000-01

The economic policy had fairly significant positive impacts on the revenue and primary deficits as well. The new economic policy brought with itself a fresh approach, the government not only liberalised the licensing it also began with the disinvestment of the public enterprises and it's holding. This had a twin effects; firstly, it lead to lowering the capital expenditure and secondly, it increased the capital receipts. Thus post 1991 there was steady decline in the primary deficit as percentage of GDP, it fell 3.95% in 1990 - 91 to 0.51% in 1996-97. However the interest burden continued to mount and thus the difference between the fiscal and primary deficits rose from 3.66 percentage points in 1990-91 to 4.19 percentage points in 1996-97 .

Deficits of the Central Government as Percentage of GDP (1990-91 to 2002-03)

Years	Gross Fiscal Deficit	Revenue Deficit	Gross Primary Deficit
1990-91	7.61	3.17	3.95
1991-92	5.39	2.41	1.44
1992-93	5.19	2.4	1.17
1993-94	6.76	3.67	2.64
1994-95	5.52	2.97	1.3
1995-96	4.91	2.42	0.83
1996-97	4.7	2.3	0.51
1997-98	5.66	2.95	1.48
1998-99	6.29	3.71	1.97
1999-00	5.18	3.34	0.72
2000-01	5.46	3.91	0.9
2001-02	5.98	4.25	1.42
2002-03	5.72	4.25	1.08

Post Fiscal Responsibility and Budget Management (FRBM) Act, 2003 till 2015-16

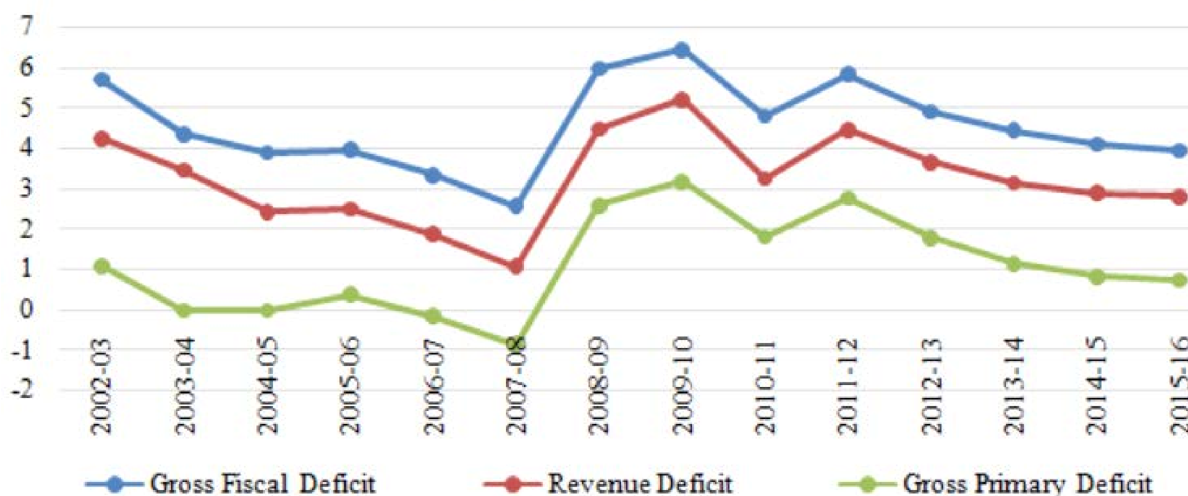
Fiscal Responsibility and Budget Management (FRBM) bill introduced in Parliament in December 2000 in order to restore fiscal discipline, the bill was referred to the Parliamentary Standing Committee on Finance, which suggested some changes in the original draft. On the recommendation of the Standing Committee, necessary amendments were made in the FRBM Bill April 2003 and after being passed by both the Houses of Parliament, it received the assent of the President on August 26, 2003. The Fiscal Responsibility and Budget Management (FRBM) Act, 2003, was brought into force on July 5, 2004.

FRBM Act gave a medium term target for balancing current revenues and expenditures and set overall limits to the fiscal deficit at 3% of GDP to be achieved according to a phased deficit reduction roadmap. The FRBM Act enhanced budgetary transparency by requiring the government to place before the Parliament on an annual basis reports related to its economic assessments, taxation and expenditure strategy and three -year rolling targets for the

revenue and fiscal balance. It also required quarterly progress review s to be placed in Parliament. The Act aimed at reducing the gross fiscal deficit by 0.5% of GDP in each financial year beginning on April 1, 2000. As a result of the efforts taken, fiscal deficit as a proportion of GDP started declining.

Deficits of the Central Government as Percentage of GDP (2002-03 to 2015-16)

Years	Gross Fiscal Deficit	Revenue Deficit	Gross Primary Deficit
2002-03	5.72	4.25	1.08
2003-04	4.34	3.46	-0.03
2004-05	3.88	2.42	-0.04
2005-06	3.96	2.5	0.37
2006-07	3.32	1.87	-0.18
2007-08	2.54	1.05	-0.88
2008-09	5.99	4.5	2.57
2009-10	6.46	5.23	3.17
2010-11	4.79	3.24	1.79
2011-12	5.84	4.46	2.75
2012-13	4.91	3.65	1.77
2013-14	4.43	3.15	1.13
2014-15	4.09	2.89	0.81
2015-16	3.94	2.8	0.71



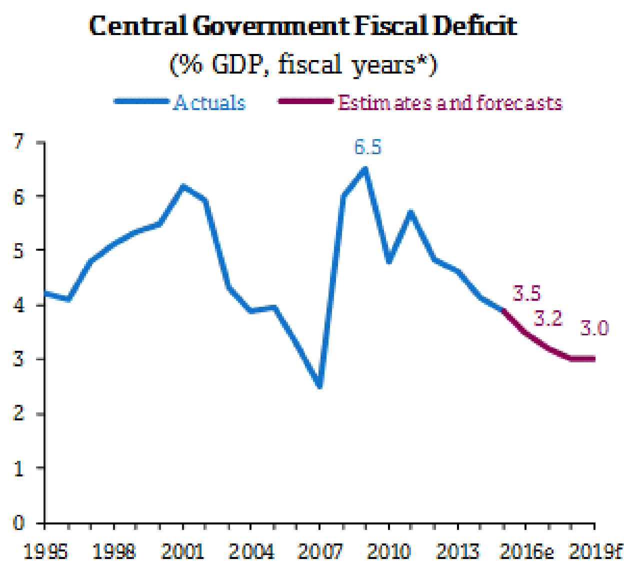
As in the above Table & Figure depicted that during 2003-04, fiscal deficit was 4.34%, which declined to 3.32% and 2.54% in 2006-07 and 2007-08 respectively. Consequently the revenue deficit also declined 3.46% in 2003-04 to 1.05% in 2007-08. The primary deficit remained negative over the same period. The sub-prime crisis that emanated from the United States (US) led to liquidity and solvency problems all around the world. While India, like other developing countries, did not have direct exposure to the crisis, the effects have been felt through credit, exports, and exchange rate channels. India's engagement with the global economy has deepened since the 1990s, making it vulnerable to global financial and economic crisis.

The macroeconomic environment has been under stress since 2008-09 when the global economic and financial crisis unfolded, necessitating rapid calibration of policies. Fiscal expansion that followed in 2008 -09 and 2009-10 did yield macroeconomic dividends in the form of a sharp recovery in 2009-10. In course of 2010-11 the non-tax revenues from auction of telecom spectrum (3G and broadband) resulted in higher than anticipated receipts. The continuance of the expansion well into 2010-11

had macroeconomic implications of higher inflation, which necessitated a tightening of monetary policy and gradually led to a slowdown in investments and GDP growth that resulted in a feedback loop to public finances through lower revenues. The fiscal deficit of 4.91 percent in 2012-13 was achieved by counter balancing the decline in tax revenue, mainly on account of economic slowdown, with higher expenditure rationalization and compression. Outlining the roadmap for fiscal consolidation, Finance Minister, ArunJaitley said, "For the year 2015-16, the government would meet the fiscal deficit of 3.9 percent of gross domestic product, and reduce it further to 3.5 percent in the next year (2016-17)"

Fiscal deficit in India (1995-2016)

At the beginning of February, India's central government announced its new budget for the fiscal year running from April 2017 to March 2018. The budget continued the medium-term path of fiscal consolidation, bringing the deficit down from an estimated 3.5% of GDP in 2016/17 to a projected 3.2% in 2017/18. However, in a nod to slowing economic growth momentum, the earlier, more austere, deficit target of 3.0% in 2017/18 was relaxed. Additionally, the budget tilts policy towards more capital spending and more progressive taxes, which should mostly offset any negative impact on growth.



During the late 1980s and early 1990s India accumulated large public debt through successive fiscal deficits. By 2003, public debt had risen to 84% of GDP, prompting the government to adopt a mandatory medium-term deficit target of 3% of GDP. After initial success, the consolidation was blown off course by the financial crisis in 2008-09, with the deficit rising to 6.5% of GDP in 2009/10.

Although subsequent efforts succeeded in bringing the deficit down, the target date for achieving the 3% deficit target has been repeatedly pushed back in 2012, 2015 and now in 2017. Following the latest budget, the central government now expects to reach a deficit of 3% of GDP in 2018/19 instead of 2017/18. For 2017/18, the budget deficit target was raised to 3.2% of GDP due to slowing growth momentum in the economy, which has been hit by weaker investment, flagging private consumption and demonetisation—the withdrawal of high denomination notes, which accounted for 86% of money in circulation.

Central Government Fiscal Estimates
(% GDP)

	2016/17e	2017/18f	Change
Deficit (a-b)	3.5	3.2	-0.3
a. Expenditure	13.4	12.7	-0.7
b. Revenue	9.8	9.5	-0.3

Source: Ministry of Finance, National Informatics Centre and QNB Economics

The focus of consolidation in the new budget is on reining in current spending after it was boosted in 2016/17 by wage increases following the 7th Pay Commission—a once-a-decade review of public sector employment. Subsidy costs will also be kept down, suggesting recent commodity price increases will largely be passed on to consumers. As a result, expenditure will be cut by around 0.7% of GDP Lower expenditure will be partially offset by lower revenue, which should fall due to cuts to the income tax rate for low income individuals (earning USD3.7k to USD7.4k per year) as well as a cut to the corporate tax rate for small companies with revenue of less than USD7.5m. The income tax cuts will be partly offset by an extra 10% income tax surcharge on individuals earning USD74k to USD149k per year.

Despite the ongoing consolidation, we expect the impact on growth to be mitigated by three factors. First, the growth fallout from lower expenditure will be partially offset by a shift towards higher quality spending. The share of capital spending in total expenditure is expected to increase from 13.9% to 14.4% as part of the government strategy to increase investment to promote growth. The bulk of the capital allocations are for road, rail and metro infrastructure projects, which should benefit growth more than current spending.

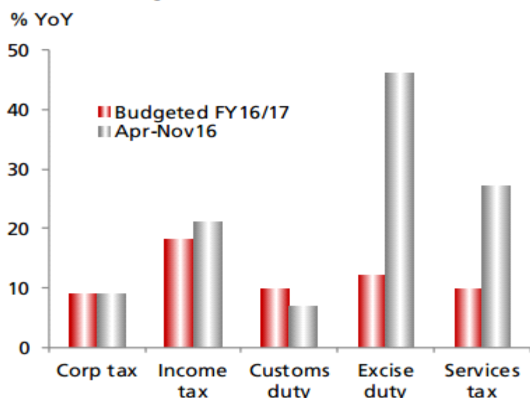
Second, the revenue measures are progressive as they reduce the burden on those on lower incomes and increase the burden on higher income earners. Those on lower incomes tend to have a higher propensity to consume, which should offset some of the consolidation

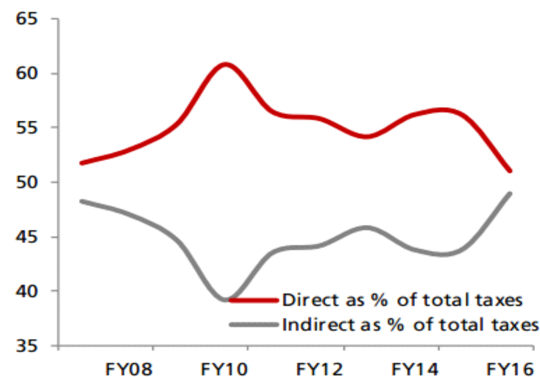
Third, the recently announced central government budget excludes state budgets, which are likely to be slightly expansionary. The states have met fiscal consolidation targets ahead of schedule and the central budget showed that they are likely to benefit from transfers of higher-than-expected tax revenue. Therefore, the states should provide a fiscal stimulus in 2017/18.

FY16/17 fiscal targets are within reach

The risk of a fiscal slippage in FY16/17 is low despite the budget deficit totaling 86% of the full-year target in Apr-Nov16. Over the remainder four months, we expect revenues to catch up with spending. December and March are seasonally strong months for direct tax revenues.

Most indirect tax revenue sub-heads are running above their budgeted pace (Chart 3). An indirect collection as a percentage of total tax revenues is likely to exceed direct receipts this year (Chart 4).





Revenues will increase from one-off sources. The Income Declaration Scheme (IDS), which ended last September, added an estimated INR 250bn (0.2% of GDP) to revenues. There will

be strong dividends of INR 660bn (0.4% of GDP) from the Reserve Bank of India (RBI). Other non-tax sources, telecom spectrum collections and divestment receipts will also add to the kitty, but miss targets. Revenues will get a short-term boost from demonetisation. Over 95% of the scrapped notes are reportedly backed with the banks. Of the remaining 5%, changes in the RBI's balance sheet might result in a one-off dividend (of 0.1-0.2% of GDP) for the government, if deemed justified. Another declaration scheme is underway with the benefits to accrue next year.

Conclusion

The aim of this study is to investigate the dynamic association between budget deficit and economic growth of India. To achieve this objective the time series data are used from 1995 to 2016. To conclude, the government appears to have successfully fine-tuned the budget to keep fiscal consolidation on track with a minimum impact on growth. We would expect the fiscal consolidation by the central government to only amount to a drag of less than 0.1 percentage points on real GDP growth. There is a risk that lower-than-expected revenue could force the government to cut spending further to keep consolidation on track. However, it is also possible that revenue could surprise to the upside as, for example, demonetisation forces the informal economy into the tax base. As a pragmatic solution to the problem FRBM Act of 2003 was introduced which set out a phased reduction roadmap, this put the Indian economy on the right track however was faced with a hiccup in the form of 2008 global credit crisis. India weathered the storm of the credit crisis well and then resumed the task of lowering the fiscal deficit through tax reforms and fiscal consolidation. These efforts bore fruits and have ensured fiscal deficit reach more comfortable levels. Therefore, this study recommends to policy makers, when they formulate the budget; the policy makers have to tolerate the budget deficit because the budget deficit is accelerating the sustainable economic growth in long – run period in Indian economy.

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