Debt Financing of Budget Deficit

Deficit financing is the budgetary situation where expenditure is higher than the revenue. It is a practice adopted for financing the excess expenditure with outside resources. The expenditure revenue gap is financed by either printing of currency or through borrowing.

Deficit financing in advanced countries is used to mean an excess of expenditure over revenue - the gap being covered by borrowing from the public by the sale of bonds and by creating new money. In India, and in other developing countries, the term deficit financing is interpreted in a restricted sense.

The National Planning Commission of India has defined deficit financing in the following way. The term **'deficit financing'** is used to denote the direct addition to gross national expenditure through budget deficits, whether the deficits are on revenue or on capital account.

The essence of such policy lies in government spending in excess of the revenue it receives. The government may cover this deficit either by running down its accumulated balances or by borrowing from the banking system (mainly from the central bank of the country).

Objectives of Deficit Financing

- To finance defense expenditures during war
- To lift the economy out of depression so that incomes, employment, investment, etc., all rise
- To activate idle resources as well as divert resources from unproductive sectors to productive sectors with the objective of increasing national income and, hence, higher economic growth
- To raise capital formation by mobilizing forced savings made through deficit financing
- To mobilize resources to finance massive plan expenditure

If the usual sources of finance are, thus, inadequate for meeting public expenditure, a government may resort to deficit financing.

Effects of Deficit Financing

1. **Leads to Inflation**: Deficit financing may lead to inflation. Due to deficit financing money supply increases & the purchasing power of the people also increase which increases the aggregate demand and the prices also increase.

2. **Adverse Effect on Savings**: Deficit financing leads to inflation and inflation affects the habit of voluntary saving adversely. Infect it is not possible for the people to maintain the previous rate of saving in the state of rising prices.

3. **Inequality:** In case of deficit financing income distribution becomes unequal. During deficit financing deflationary pressure can be seen on the economy which makes the rich richer and the poor, poorer. The fix wage earners are badly affected and their standard of living deteriorates thus no gap between rich & poor increases.

4. **Adverse Effect on Investment**: Deficit financing effects investment adversely when there is inflation in the economy trade unions make demand for higher wages for that they go for strikes and lock outs which decreases the efficiency of Labor and creates uncertainty in the business which a decreases the level of investment of the country.

5. **Problem in BOP:** Deficit financing leads to inflation. A high price level as compared to other countries will make the exports more expensive and thus they start declining. On the other hand, rise in domestic income and price may encourage people to import more commodities from abroad. This will create a deficit in balance of payment and the balance of payment will become unfavorable.

6. **Change in Pattern of Investment:** Deficit financing leads to inflation. During inflation prices rise and reach to a very high level in that case people instead of indulging into productive activities they start doing speculative activities.

Public Debt

In order to meet its expenditure, every government takes several types of loans. These loans are called public debt. According to **Prof. Taylor**, "Government debt arises out of borrowings by the treasury from banks, business organizations and individuals." Thus, public debt refers to all types of borrowings made by the government. It includes both internal borrowings and the external borrowings.

Importance of Public Debt

In modern age, the economic & developmental functions of the government have multiplied. Owing to the increase in these functions, public expenditure, too, has increased correspondingly. In order to meet this increase in expenditure, the government has to secure money from various sources. The significance of the public debt becomes clear by the following factors:

1. **Economic Development:** Most of the development projects are long term, in order to complete these capital & long term projects; the government has to spend a lot of money.

This money cannot be mobilized only through taxes alone; seeking debt becomes imperative for it.

2. **Breaking of the Vicious Circle of Poverty:** In order to break this vicious circle, it is essential for the government to increase the amount of investment. Public debt is an important means of securing capital for investment.

3. **Social Welfare:** Development of social welfare schemes like education, health, general insurance, for this a lot of money is required, thus public debt is essential.

4. **Emergency:** A lot of money has to be spent by the government at the time of wars, floods, epidemics, etc. The requirement of money in such situations is met by public debt.

5. **Economic Control:** Sometimes, the supply of money increases with the people. Because of it, prices also go up. So, in order to reduce prices, it is essential to bring down the supply of money. In order to reduce the supply of money, the government borrows money from public even though it does not require the amount. As a result, public debts are secured for implementation of economic control also.

6. **Safeguarding Against Depression:** During depression, aggregate demand in the country is low. As a result, production is low & unemployment increases. Public expenditure has to be compulsorily increased in order to avoid the situation of low production and unemployment.

7. **Special Importance to Underdeveloped Countries:** In underdeveloped countries, only a limited income can be had by taxes. Public opposes both the additional taxation and the increase in the existing rate of taxes. Thus, the importance of public debt has increased.

8. **To Bridge Temporary Deficit:** The government secures loans in order to bridge the temporary budget deficit. It is so because the taxes do not yield income quickly, and people, too, oppose temporary taxes.

9. **Establishment of Public Enterprises:** The government takes big loans for establishment of public enterprises or sometimes have to take over sick units. For the financing of these activities, loans are taken.

10. **Proper Distribution of Resources:** Sometimes there is mal-distribution of resources due to growth of monopolistic tendencies. In order to end these tendencies, either the government itself enters or encourages other firms to enter the market. To achieve this objective, government has to borrow funds.

11. **Development of Infrastructure:** Government has to spend lot of resources on the development of roads, power generation, transport & irrigation facilities & means of communication. All this necessitates large scale public borrowing.