

# IMPACT OF FISCAL DEFICIT ON ECONOMIC GROWTH IN VARIOUS SCHOOLS OF THOUGHT – A THEORETICAL FRAMEWORK

**Prof. Dinesh Patel**

Assistant Professor (Economics)  
JG College of Commerce,  
Ahmedabad – 380054  
Email id: pateldinesh503@gmail.com

## Abstract

*In the development of an economy fiscal policy plays a very important role. Impact of fiscal deficit on economic growth is one of the alarming issues not only for India but also for the other emerging economies. The role of fiscal policy and fiscal deficit in influencing economic growth has been a widely debated issue in economic literature. In macroeconomic literature as each major school of economic thought views impact of budget deficits on economic activity situation. There is clear a division of opinion on this issue. Some economists argue that budget deficit have a positive effect, some argue negative effect and neutral effect on the macroeconomic activity. To understand this, the paper examines theoretical perspective of different economist view like alternative measures of government deficit and alternative school of thought (Classical, Neo-classical, and Keynesian, Ricardian equivalence) to show various impact of fiscal deficit on economic growth.*

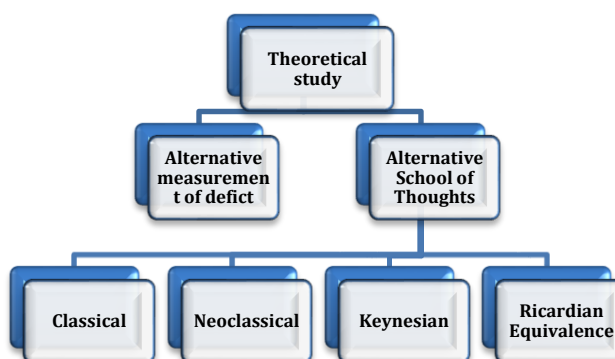
## INTRODUCTION

Fiscal policy plays a very important role in the development of an economy. Not only in India but also for the other emerging economies the impact of fiscal deficit on economic growth is one of the alarming issues. We know that fiscal deficit is the difference between government expenditures and government revenue. Implementation of sound policies is the only way to achieve economic growth. But are the fiscal deficits always pleasing? The answer has many dimensions, including whether the government borrowing is financing revenue expenditure (non-development) or development expenditure, whether the deficit is sustainable, and how it is being financed.

The role of fiscal policy and fiscal deficit in influencing economic growth has been a widely debated issue in economic literature. In macroeconomic literature as each major school of economic thought views impact of budget deficits on economic activity situation. There is clear a division of opinion on this issue.

- ❖ Some economists argue that budget deficit have a positive effect on the macroeconomic activity.
- ❖ While some economists argue that budget deficit have detrimental effect on economic growth.
- ❖ Some another view states that budget deficits are neutral in terms of its effect on economic growth.

### Fiscal Deficit and Economic Growth: Theoretical and Empirical



### ❖ The Theoretical Perspectives

Does fiscal deficit really impact economic growth? This has been an argumentative topic debated in the economic literature without reaching any conclusive outcome. Fiscal deficit is stated to be one of the significant

variables to have a sway on growth. In the light of this, an attempt is made here to review theoretical literature relating to the impact of fiscal deficit on economic growth as follows:

- (A) Alternative measures of government deficit
  - (B) Alternative school of thought
  - (i) The Classical View
  - (ii) The Neoclassical View
  - (iii) The Keynesian View
  - (iv) Ricardian Equivalence Hypothesis
- 
- (A) Alternative Measures of Government Deficit

The term “budget deficit” which is considered to be undesirable and dangerous appears regularly in government policy documents, news articles and debates. Although now a days the attention given to the budget deficit issue is appears quite new, but it has been discussed for more than two centuries right from Adam Smith.

**Adam Smith (1723-1790)** has discussed the budget deficit issue in his 1776 book: “An Inquiry into the Nature and Causes of the Wealth of Nations”. According to Smith the budget must be balanced and it should be the norm of government budgeting. However these norms may be changed during the situations like emergency or war.

**Rutayisire (1987)** has criticized the use of the conventional deficit. According to him conventional deficit has been failed to adjust medium or long term objectives of economic policy with fiscal policy and isolate cyclical influences of the economy on the budget. He suggested that the budget should not be balancing the conventional budget but manipulated based on cyclically standardized budget.

**According to Blejer and Cheasty (1991)** we need different fiscal policies depending on how fiscal deficit is measured and over what period of time. He suggested that we required public sector’s to solve the economic problems and to find appropriate fiscal policies to solve the problem.

According to World Bank and the IMF, there are some of different ways to measure the conventional budget deficit exists. The most commonly accepted measure used by government world-wide to define the conventional budget is the resources utilized by the government in a fiscal year that need to be financed after revenues were deducted from the expenditure.

**According to Blejer and Cheasty (1993)**, Conventional deficit reflects the financing gap that needs to be closed by way of net lending, including lending from central bank. The conventional deficit can be measure as the difference or gap between current revenues and current expenditure of the government.

**According to Agenor and Montiel (1999)**, the conventional budget deficit can be calculated on the basis of cash or payment order (accrual) basis. In cash basis the deficit equals the difference between total cash flow expenditure and fiscal revenue. In payment order case the deficit shows accrued income and spending flows regardless of whether they involve cash payment or not.

Since the complications created by the changes in inflation in the interpretation of conventional deficit make an evaluation of fiscal performance over time difficult so to overcome the shortcoming of the conventional deficit measures, alternative measures of the fiscal deficit that supplement the information provided by the conventional deficit are necessary. These measures are discussed by several authors including Buiters (1983), Tanzi et al (1987), Blejer and Cheasty (1991) and Easterly Schmidt-Hebble (1994).

The operational or inflation-adjusted budget deficit is used to remove the effect of inflation from the interest payments; this is defined as conventional deficit less part of the debt service that compensates debt holders for actual inflation. Alternatively, it can be defined as the primary deficit plus real interest payments. This measurement of fiscal deficit is useful for policy making when inflation is very high.

There are also other forms of measuring the fiscal deficit which depend on the current problem at hand, such as the financeable or sustainable fiscal deficit, which measure the deficit that is comparable with sustainable economic targets for growth and output. If the effects of inflation are not removed the deficit would increase at a high rate. The primary deficit can be used to remove the effects of previous deficits on the current deficit.

❖ **(B) Alternative School of Thought**

The relationship between fiscal deficit and growth is a controversial topic in economic theory, empirical research and economic policy making. There is no agreement among economists or it is difficult to say on theoretical ground, whether fiscal deficit is good, bad or neutral in terms of its effect on growth.

There are mainly four paradigms which analyze the macroeconomic effects of fiscal deficit. These four schools of thought concerning the impact of fiscal deficit on growth: **Classical, Neo-classical, Keynesian and Ricardian Equivalence**. Since each is providing different paradigms, it is necessary to review theoretical discussion on the three alternative frameworks.

**(i) The Classical View**

Although the discussion of budget deficit issue appears quite new, but actually it is found that it has been analyzed for more than two centuries. **Adam Smith (1723-1790)** has discussed the budget deficit issue in his 1776 book: „*An Inquiry into the Nature and Causes of the Wealth of Nations*’. According to Smith *the budget must be balanced and it should be the norm of government budgeting. However these norms may be changed or violated during the situations like war or emergency.* According to classical view **fiscal deficit creates negative effect on economic growth.**

He concluded that government’s ability to borrow increased their desire to wage war. He stated that “Wars would in general be more speedily concluded and less wantonly undertaken” if governments had to raise money by taxes instead of borrowing. According to Smith the desire of government officials to spend, the inability and fear of raising taxes, and the willingness of capitalists to lend are the actors that lead to government deficits. The general conclusion of Smith is that “budget deficits lead to public debts that would, in the long-run probably ruin all the great nations of Europe”.

For the most part, Smith (writing in 1776) considered the transfer of resources from the private sector, whether through taxation or borrowing. Smith believed that “saving is spending” because one man’s saving becomes another man’s investment. Adam Smith for example, opposed extensive government involvement for both philosophical and crowding out reasons. Borrowing funds from the public to finance government spending was asserted to involve the “**destruction of some capital which had before existed in the country; by the perversion of some portion of the annual produce which had before been destined for the maintenance labour**”.

The classical economists believe that an increase in government investment at the cost of private investment is a result of government financed by domestic debt. A decline in consumption and private investment can be seen when interest rates will increase and when governments borrow from the domestic market. This is the popular “**crowding-out**” argument against government spending. Massive government spending through borrowing may lead to “crowding-out” effect, but the protagonist of fiscal deficits sees the other side of the coin. They counter the “crowding-out” assertion agreeing to the fact that though crowding out is possible in financial markets; there is a converse effect as well. The conjecture, known as “crowding in”, contends that government spending will create an increase in aggregate demand.

Later classical economists, such as **John Stuart Mill and J.B. Say**, writing primarily in the first half of the nineteenth century, saw in Adam Smith’s maxim a guarantee of full employment. Private investment was sufficient to utilize the funds provided by private saving because government spending was considered unnecessary as a stabilization tool.

The most elementary case for crowding out may be examined in a “**Say’s Law**” framework. Say’s law is known as “supply creates its own demand.” In an economy in which Say’s law is operative, attempts by the government made to either borrowing from the public or taxation to increase total spending, by rising government expenditure and financing the increasing budget. In the classical case there will be a rightward shift in the IS curve due to the effect of deficit-financing i.e. increase in the level of government expenditures. Therefore, the level of income velocity of money remains unchanged but the equilibrium interest rate rises. In this case, the increase in the interest rate precisely offsets the increase in government expenditure which will also results in a reduction in private investment spending.

**(ii) The Neoclassical View**

According to neoclassical view **fiscal deficit creates negative effect on economic growth.**

Neo-Classical view states that increase in public expenditure has crowding-out effect on private investment. Increase in government expenditure reduces economic growth by crowding-out effect because government spending is less productive than investment in private sector. In this view, fiscal deficits increase life span consumption by transferring tax burden to the coming generations. In the globalized era, government has to go for huge foreign debt when our national saving decrease which results in decrease in total exports due to an appreciation of the currency in the domestic market.

According to Neoclassical model individuals over their entire life cycle planning their consumption. They assume full employment of resources is attained. When we are shifting taxes to future generations at that time budget deficits increase current consumption. When we assuming full employment of resources we can find negative relationship between consumption and saving and due to that the increased consumption implies a decrease in saving. To bring equilibrium in the capital markets decrease in saving results in high interest rate which is very much required but the higher interest rates declines private investment and economic growth will decrease.

**Yellen (1989)** argued that in standard neoclassical macroeconomic models, the levels of consumption, investment and net export is affected by the method selected by the government to finance its spending program. Such models assume that if a given government-spending programme is financed by issuing bonds rather than through current taxation the aggregate consumption is higher and national (private plus public) saving lower.

According to **Baxter and King (1993)**, the neoclassical model imply that there is a negative effect of government spending on GDP is depends on how increase in government spending impact consumption and private investment. Neoclassical economists believe that increase in government spending and tax cut “crowd out” private sector investment by increasing interest rates, the mechanism can be describe as follows: If government borrowing creates a greater demand for money and funds than it supplied, it leads to higher interest rates or higher user cost of capital, creating higher prices for private firms to borrow money. As interest rates increase, firm face a lower rate of return and thus reduce investment. So public sector gets more, it “crowd out” private sector investment. As the private sector firm take on fewer investment, they also produce less and reduce output and thus GDP falls. Since Neoclassical model assumes that economy is at full employment or capacity suggest that increase in deficit will also create long term inflationary effects. Thus, neoclassical economists would expect to find a negative relationship between government spending and consumption, private investment and GDP.

**Bernheim. B. Douglas (1989)** summarizes the main empirical implication of neoclassical view of budget deficit. Temporary deficits have either a negligible or perverse effect on the most economic variables (including consumption, savings and interest rates) if permanent deficits significantly depress capital accumulation when consumers are rational, farsighted and have accesses to perfect capital market. The impact of permanent deficits remains qualitatively unchanged if many consumers are either liquidity constrained. In the short run temporary deficits should decrease savings and increase interest rates. Thus, the neoclassical paradigm does not tie down the effects of temporary deficits but they were concern with the effect of permanent deficits.

### ***(iii) The Keynesian View***

**John Maynard Keynes in 1936** stated that government spending does not crowd out private spending in his landmark book, “The General Theory of Employment, Interest and Money”  
Keynes advocates that **fiscal deficit creates positive effect on economic growth.**

The Keynesian views argue that when government expenditure rises it results in more domestic output within the short period because it makes households feel wealthier, thus rising total private and public consumption expenditure. When there is an increase in the aggregate demand, budget deficit has a positive effect on macroeconomic activity, thereby stimulating saving and capital formation. **(Chakraborty and Chakraborty, 2006). This is known as the “crowding-in” effect, which has a positive impact on growth.**

The Keynesian view is different from neo-classical view. Keynesian View advocated that out of their disposable income economic agents have high MPC (marginal propensity to consume) and they are narrow-minded. Through multiplier process by internal and external borrowing boost in autonomous government expenditure results in output expansion. The conventional Keynesian agenda does not differentiate between alternative mode of financing the fiscal deficit via monetization or domestic or foreign borrowing, nor differentiate between alternative uses of the fiscal deficit as between government consumption or investment expenditure.

Keynesian model also predict that there will be an increase in the transaction demand for money due to the multiplier-based increase of aggregate output. Multiplier effect will be reduced if there is rise in interest rates when money supply is constant and deficits are financed by domestic market but the Keynesians argue that at any given rate of interest an increased aggregate demand improves the profitability of private investment and leads to higher investment. Keynesians argue that even if interest rate rises, deficits may motivate savings and investment mainly because of the employment of hitherto unutilized resources. The effect of a rise in interest rate may thus be more than neutralized by the increased profitability of investment.

It is worth noting here that the Keynesian view differs from neoclassical paradigm in two fundamental ways. **(Bernheim B. D. (1989))**

- (a) It allows for the possibility that some economic resources are unemployed.
- (b) It presupposes the existence of a large number of myopic, liquidity constrained individuals. This second assumption guarantees that aggregate consumption is very sensitive to changes in disposable income.

In the simplest and most naïve Keynesian model, multiplier based expansion of output leads to rise in demand for money. If the money supply is fixed (that is, the deficit is bond financed), interest rate must rise, and private investment fall. This in turn reduces output and partially offset the Keynesian multiplier effect.

#### ***(iv) The Ricardian Equivalence View***

According to Ricardian Equivalence view, **fiscal deficit has neutral impact on economic growth.**

An alternative view of the effect of budget deficit on economic growth is called Ricardian Equivalence. It can be stated that in present if fiscal deficit is more due to that the future generation will have to suffer more because burden of fiscal deficit of current period would be borne by future generation by paying more taxes.

Fiscal deficit as a result of government spending is an important instrument for offsetting the impact of revenue shocks or for meeting the prerequisites of heavy expenditures and its financing by the means of taxes may be extended for next generation. The Ricardian equivalence implies that deficit is merely postponement of taxes and it cannot shift the aggregate demand curve in the economy. Therefore fiscal deficit is neither good nor ill in terms of its impact on growth.

**According to Bernheim B. D. (1989)** The Ricardian Equivalence view described above is based on seven main restrictive assumptions:

- Successive generations are linked by altruistically motivated transfer
- Capital, markets are either perfect, or fail in specific ways
- Consumers are rational and foresighted
- The postponement of taxes dose not redistribute resources across families with systematically different marginal propensity to consume
- Taxes are non-distortionary
- The use of deficit cannot create value (not even through bubbles)
- The availability of deficit cannot finance as a fiscal instrument does not alter the political process.

**Barro (1989)** argued that due to Ricardian Equivalence tax cut will not have an impact on the overall economy. **According to Barro (1989)**, budget deficit would occur if government does not cover its expenditure by tax. For budget deficit if money will be arranged by debt, households would know that government has to increase taxes in the near future to compensate interest payments and principle amount. This will result in rise in individual saving which leads to rise in the national saving and therefore offset any increase in interest rate and the investment unchanged. Thus the interest rates and private investment are remained unchanged.

**Rangarajan and Srivastava, (2005)** noted that, if household spending decisions are based on present value of their incomes that takes into account the present value of their future tax liability fiscal deficit will not have much impact on aggregate demand from Ricardian Equivalence perspective and in that case we would not fond any relationship between tax changes, and consumption, investment and output.

Consequently, the Ricardian view yields a radically different notion of the national debt. The national debt should be viewed as a blessing, not a curse for those who believe in the benefits of deficit financing. For those who believe in Ricardian equivalence, the national debt represents the cumulative amount of this net transfer and deficit spending merely results in a redistribution of income.

## CONCLUSION

In the paper we have examined various theoretical perspective of different economist view like alternative measures of government deficit and alternative school of thought (Classical, Neo-classical, and Keynesian, Ricardian equivalence) to show various impact of fiscal deficit on economic growth. From the study we found that According to classical and neo-classical view fiscal deficit creates negative effect on economic growth. Keynes advocates that fiscal deficit creates positive effect on economic growth and According to Ricardian Equivalence view fiscal deficit has neutral impact on economic growth.

## REFERENCES

- [1] Rutayisire, L.W. (1987), "Measurement of Government Deficit and Fiscal Stance in a less Developed Economy: The Case of Tanzania", *World Development*, Oxford Pergamon Press, vol.15, pp. 1337-51.
- [2] Blejer, M. & Cheasty, A. (1991), "Analytical and Methodological Issues in the Measurement of Fiscal Deficits", *IMF Working Papers*, no. 90/105(November), pp. 1-61.
- [3] Blejer, M.I. & Cheasty, A. (ed.) (1993), "How to Measure the Fiscal Deficit: Analytical and Methodological Issues", International Monetary Fund, Washington, D.C.
- [4] Agenor, P. R. and Montiel, P. J. (1999), "Development Macroeconomics, 2nd ed.", Princeton University Press, New Jersey.
- [5] Yellen, J. L. (1989), "Symposium on Budget Deficit", *Journal of Economic Perspectives*, vol. 3, no.2, pp.17-21.
- [6] Baxter, M and King, R., (1993), "Measuring Business Cycles Approximate Band-Pass Filters for Economic Time Series", *NBER Working Paper Series*, Working Paper No.5022.
- [7] Bernheim B. D. (1989), "A Neoclassical Perspective on Budget Deficits", *Journal of Economic Perspective*, vol. 3, no.2, (spring), pp.60.
- [8] John Maynard Keynes. (1936), "The General Theory of Employment, Interest and Money", Harcourt, Brace and Company, New York, pp. 119-20.
- [9] Chakraborty, P. and Chakraborty, L. (2006), "Is Fiscal Policy Contra cyclical in India: An Empirical Analysis", *MRPA Paper No. 7604*, Online at <http://mpr.ub.uni-muenchen.de/7604/>.
- [10] Bernheim B. D. (1989), "A Neoclassical Perspective on Budget Deficits", *Journal of Economic Perspective*, vol. 3, no.2, (spring), pp.60.
- [11] Bernheim B. D. (1989), "A Neoclassical Perspective on Budget Deficits", *Journal of Economic Perspective*, vol. 3, no.2, (spring), pp.63.
- [12] Barro, R. J. (1989), "The Ricardian Approach to Budget Deficits", *Journal of Economic Perspectives*, American Economic Association, Spring vol. 3(2), pp. 37-54.
- [13] Rangarajan, C. and Srivastava, D. (2005), "Fiscal Deficits and Government Debt in India: Implication for Growth and Stabilization", *NIPFM Working Paper 05/035*, National Institute of Public Finance and Policy New Delhi, India.