Effect of Budget Deficit on Growth of Economy of India between 1991-2016

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Abstract
This paper seeks to analyze the dynamic interaction between the budget deficit and growth in India between the year 1991 and 2016. Within the frame of discussing the fiscal policy issues, the impact of the budget deficit on general macroeconomic performance is highly important in view of being capable of further development. Based on time-series evidence and the Econometric models, including the Autoregressive Distributed Lag (ARDL) model and the Granger causality, this study examines the short- and long- term effects of fiscal deficits on economic performance. The evidence indicates that continued budget deficits do not have significant impact, although in the short-term, it can result in the growth of the economy as the government increases government spending, but in the long-term, there is a danger of crowding out private investments and raising inflation factors. The relevance of the Fiscal Responsibility and Budget Management (FRBM) Act, as a critical policy measure, is therefore well emphasized in the study owing to the necessity of proper fiscal management discipline. Such observations bring to the more extensive discussion how fiscal policy can mediate between the economic stimulus and financial stability in developing economies like India.
Keywords: Budget deficit, Economic growth, Fiscal policy, GDP, ARDL, FRBM Act

Introduction

It goes without saying that successful planning is the key to success in every organization and for economic factors. Budgeting, in the form of financial planning, assists in the establishment of development guidelines. This is when the government spends more money than what it brings in revenue, which depends on GDP and economic developments. Production is affected by economic growth which increases living standards due to policies of the government. Domestic demand will also be shaped by government spending and tax revenue; While in India, the excessive demand owing to persistent fiscal deficits has been responsible for inflation. A deficit indicates the cumulative excess of government expenditures over revenues, and the government meets such deficits either through market borrowing or in the case of RBI, which has the authority to generate new money. This leads to an increase in income and aggregate demand likely exacerbating inflation when the aggregate supply is inelastic.

Budget deficits are a subject of debate among economists. To traditionalists they are worse than free money, but to Ricardians they do not destroy the economy at all. The perennial current account deficit of India has created international debts for the nation impacting growth, inflation, and investments,While deficits are thought by some economists to accelerate growth when the proceeds are used to increase education and health, neo-classical economists que them into the junk-pile of negatives. Long-term growth is best supported by a balanced budget because ongoing deficits mean negative public savings and tend to slow economic growth.

Methodology

The methodology used to study the effect of budget deficit on economic growth in India is the combination of qualitative and analysis. It employs statistical methods like econometric models (for instance, an Autoregressive Distributed Lag (ARDL) model or Vector Auto regression (VAR)) to study the impact of fiscal deficits on GDP growth. We use secondary data which include some government reports, RBI report, and some international institutions like the IMF, World Bank. When it spans several years, a time-series analysis exposes trends of the economic causal relationship. Research may also include Granger causality tests do budget deficits cause expansion or does slow growth increase deficits? In addition, this process of policy analysis and literature review is extremely important in informing how these findings relate to the unique economic environment in India, with due regard to inflation, interest rates, and external debt.

Objectives

The aim of this research paper is to study the impact of budget deficit of India over the economic growth, investment, inflation and overall macroeconomic stability. Its planning is to asses whether elevated deficits boost growth as a result of higher public outlays, or whether the excessive deficits crowd out private investment owing to interest rate hikes. It will also review the sustainability of fiscal policies in India and the implications of fiscal measures on the financial market in the long-term. The impact of paying the piper how policymakers can respond to the potential (but not certain) costs of a future set of persistent budget deficits and build a bridge between fiscal stimulus and stability without a fiscal cliff: The embrace of permanent budget deficits highlights the need to bridge the junction between fiscal stimulus and stability without unbalancing the ship.

The Deficit and the Debt

When a country has a deficit every year, that produces an increase in the years' sovereign debt The second is that as debt increases, the deficit compounds in part through interest payments that create zero economic value and, after a point, act as a drag on growth when diverted from productive uses. Second, a debt to GDP ratio above 77% leads to fears among customers about repayment ability which leads them to charge greater interest rates on riskier assets making the deficit larger. But this can create a self-perpetuating cycle where it becomes too expensive to roll over debt, and defaults occur, as happened in Greece in 2009.

The way this plays out in the U.S. is different, though. The dollar advanced 22% versus the euro because it is a safe-haven currency at heart during the 2008 financial crisis. The dollar rose even more after the eurozone debt crisis broke in 2010, which drove U.S. interest lower. Yet that has not stopped lawmakers from doing their usual thing and ignoring rising note yields despite a doubling of U.S. debt. And yet in 2016, with interest rates expected to rise, the interest on national debt was projected to do so in such a way that over four years the U.S. treasury had to pay for it or defaulted on the bonds.

Review of Literature

As already observed for the relation and challenges among budget deficit and growth, many empirical studies have been conducted in this respect. That point is obviously addressed by these studies.

(Khedair) Studies of the relationship between budget deficit and some macroeconomic variables of the major industrials countries. This result confirmed, in which the budget deficit had a negative relationship with the determinants of trade balance in industrial countries, while the economic growth indicator had a positive relationship with the determinants of trade balance in industrial countries.

In annual time series data of Pakistan covering a sample period of 1971-2007, (Ahmad) took budget deficit as a variable and checked its effect on economic growth. This tested the stationarity of the variables over the period with the Augmented Dickey Fuller test, while the Granger Causation Test tests to see if between the variables, causality exists. The findings from this research revealed a significant relationship between budget deficit and economic development of Pakistan. However it was weak and also showed the bi-dual relationship of cause and affect between budget deficit and growth.

ARDL approach on the relationship of Budget deficit and economic growth in Malaysia, This study uses quarterly data for the period of 2000-2011 on these four variables, or dependent variables in turn, real GDP per capita growth, the n growth of federal government debt, n growth of productive government expenditure n growth of non- productive government expenditure. As an example, ln GDP were regressed as dependent variable and other like independent variable etc. (Rahaman).

The aim of this research is to look into some problems created by fiscal deficit leading towards investment and ultimately GDP growth of Pakistan Methodology: Using time series data of 1980-2009, the study uses a simultaneous equations model as an analysis method Find Statics/temporal/ Simultaneous equations model Keywords: fiscal deficit, investment, GDP growth, Pakistan Two — stage least squares used to estimate simultaneous equation models While the sub-factors in first study replaced to our sample as single entity amongst the GDP per capita, export, import, fiscal deficit, interest rate, inflation and population growth the sub-factors in second study fed factors separately in order to see to what extent budget deficit is responsible for investment- and therefore economic growth- in Pakistan. This study indicates economy of Pakistan as per government financial plan deficiency, producing are take good and are well known effects for us.

(Edame and Okoi) adopted time series annual data for 1986 2013. This study used the common use method on macroeconomic variables in the Nigeria; it established the unit root test and together with co-integration test high co-integration was established. But / above states putting within the literature that majority of analysis done at the point the world in the economic development of the budget deficit. However, none of them, as far as our knowledge concerns, has examined the budget deficit–growth nexus over the time. In the absence of even the semblance of serious research work, one is unlikely to witness visible outcomes, particularly so in the Sri Lankan perform acne equivalent t domain as the budget deficit–economic grow th impacts. Therefore, in the present paper, we will exploit this dose of the void of literature.

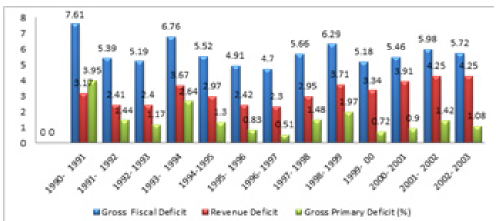
Post Liberalization Period from 1990-91 to 2002-03 till FRBM Act

In the period 1990-91 with interest rates high, our foreign exchange reserves low and foreign debt high, high interest costs had caused a deep and severe crisis in the Indian economy on the eve of the FRBM Act being enacted in 2002-03 with our deficits on an explosive growth path. Conditions worsened under the Gulf War, raising oil prices, forcing investors to withdrawn their funds from the country and leaving only three weeks of imports in avoidable foreign exchange reserves. India sought emergency IMF funds to avert default Consequently, PM Narasimha Rao liberalized the economy in 1991 and launched the New Economic Policy (NEP) which shifted the direction towards Liberalization, Privatization and Globalization (LPG). It scrapped quotas and licenses, de-licensed sectors, opened the floodgates for foreign investment, privatized state-owned companies, and made the currency partially convertible.

It also restructured the tax regime seeking to boost revenues through a transition from trade to domestic consumption taxes (VAT) and direct taxes. Due to this, the share of direct taxes in aggregate resource rose from 15% (1991-92) to 26% (2000-01), whereas the share of indirect taxes fell from 61% to 45%.

The policies implemented resulted in substantial fiscal gains, with the primary deficit declining from 3.95% of GDP (1990-91) to 0.51% (1996-97) But the increasing burden of interest increased the fiscal gap, with the gap between fiscal and primary deficits growing from 3.66% (1990-91) to 4.19% (1996-97). This helped strengthen the government finances by depressing capital outlay while increasing capital revenue along with disinvestment policy.

GDP Ratio of Central Government Fiscal Deficits from 1990-91 to 2002-03

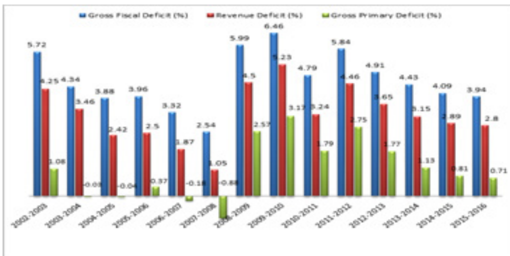


After Implementation of FRBM Act, 2003 up to 2015-16

The FRBM bill, aimed to reestablish fiscal discipline, was first presented in Parliament in December, 2000, though it passed through the Parliamentary Standing Committee on Finance, only a few changes were suggested with respect to the original draft. The FRBM Bill April 2003 was also passed by both the Houses of Parliament and gave its assent on 26th August, 2003 and was recommended to be amended by the Standing Committee. India Fiscal Responsibility and Budget Management (FRBM) Act 2003.

The FRBM Act prescribed in the medium term a balancing of the aggregate revenues and the expenditures in such a manner so as to bring in an improvement in the fiscal balance and further the fiscal deficit limits to be expressed in relation to the GDP must be less than or equal to a level of 3 per cent; on the basis of rolling verification periods prescribed in the phased roadmap for fiscal deficit consolidation. The FRBM Act did add some additional transparency to the budget process too every year the government had to address it with reports on economic outlook, tax and expenditure policy as well as three-year rolling targets on revenue and fiscal balance. It also needed to submit quarterly progress updates to Parliament. The objective was to reduce the gross fiscal deficit by 0.5% of GDP each financial year beginning 1 April 2000 and to maintain it at this level thereafter. Fiscal deficit as a share of GDP began to decline over the measures.

Central Government Fiscal Deficits to GDP ratio (2002-03 to 2015-16)

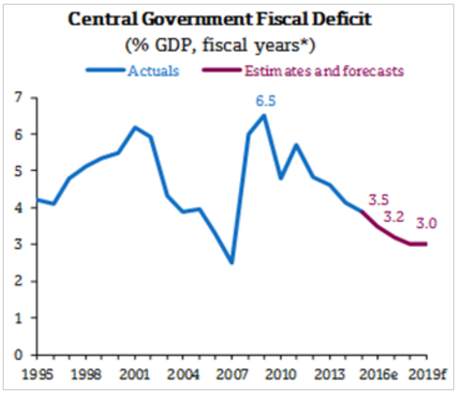


The sub-prime crisis that started in the US, went global and caused a chain of liability and solvency crises. Development in the rest of the world, gas prices (India skies are certainly not blue) and a combination of both factors scythes what is a major international crisis — on the one hand a booming economy which masks an immediate impact of the crisis on it, and on the other an isolationist development from the developments in the other part of the world, so automatic channels through credit, exports and exchange rates control and act in the target countries including India. The global financial and economic crisis started to invade India due to the deepening of integration of Indian economy into world economy since 1990s.

As the global economic & financial crisis burst out about 2008-09 and the economic conditions had started to suffer deficits following the global slowdown, the macroeconomic environment maintained demanding re-adaptation. Now, the macroeconomic outcomes of this fiscal expansion (at least undertaken subsequently in 2008-09 & 2009-10) was a strong recovery in 2009-10. In course of time, one such source translates into excess collections during 2010-11 for example, Non Tax earnings from auctioning of Telecom spectrum (3G and Broadband) The whole thing was just too much inflation that needed some monetary policy restriction with investment and GDP growth slowing down with a trickle down nature from monetary policy to the real economy that then fed-back on public finances through lower revenues. The manner, in which fiscal deficit of 4.91percent had been achieved in 2012-13; tax revenue shortfall was offset by, interalia, higher emphasis on expenditure rationalization and compression on account of largely a slowdown in economy. Presenting the fiscal consolidation roadmap for the new government in his maiden Budget, new Finance Minister Arun Jaitley said, "The fiscal deficit of the government will be 3.9 per cent of gross domestic product (GDP) for the year 2015-16, and 3.5 per cent in the next leg (2016-17).

India's Fiscal Deficit from 1995 to 2016

India's Finance Minister Arun Jaitley tabled the budget for the fiscal year beginning April 2017 and ending March 2018 in early February. The budget reiterated the aim of further fiscal consolidation, cutting the deficit by 0.3 percentage points to 3.2% of GDP in 2017/18, down from 3.5% of GDP in 2016/17. The original target of 3.0% in 2017/18 was, however, eased in response to weaker domestic growth momentum. Although the budget balance has worsened as a result of this adjustment, with its focus on the more benign sectors of the economy capital spending and progressive taxation that bodes poorly for growth, the anticipated negatives from this should be modest.



As a consequence, India continued to run large fiscal deficits through the late 1980s and into the early 1990s, which led to a growing public debt. Public Debt in 2003 / at the top of the range: 84% of GDP of public debt; medium term deficit target (including structural deficit) of 3% of GDP for governments / Consolidation had been going well when the financial crisis interrupted at the end of 2008-09 and drove the deficit to 6.5 percent of GDP in 2009/2010.

Later efforts narrowed the deficit but deadlines to reach the 3% target have been pushed further and further back -- from 2012 to 2015 and now 2017. However, the central government is now set to reach a 3% of GDP deficit in 2018/19, not in 2017/18, a consequence of this budget. Sluggish growth impulses in a demonetized economy plagued with one-off activity, eased investments and subdued private consumption, managed the 2017/18 budget deficit target to a well-publicized 3.2% of GDP a demonetization that had jerked 86% of money in circulation, most of which was in the form of larger notes.

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

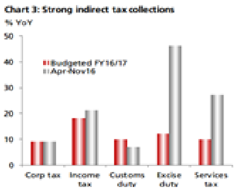
Wrapping the new budget is resting on curtailment in current spend which was boosted at the time of 2016/17 on account of hike in salaries on account of the 7th Pay Commission — a decadal evolution of wages in the government sector. However, declining subsidy costs will mean that most of this latest run in world commodity prices will be passed on to consumers, Equating to a reduction in migration-related expenditure of approximately 0.7 percent of GDP.

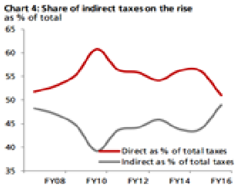
Pyne, though, said the savings from lower spending would also be offset in part by reduced revenue, which will fall as a result of lower income rates for low-income earners (those on between USD3,700 and USD7,400 a year) and cuts to the corporate tax rate for small business with revenue below USD7.5 million. The cuts in income tax will be partly offset by a 10% income tax surcharge on those earning between USD74,000 and USD149,000 a year That said, we believe the positive impact of consolidation on growth this year is to some extent counteracted by three factors. The second is that the reduction in growth from diminished expenditure will be somewhat counterbalanced as spending shifts to more efficient forms. Following the government strategy of higher capex for growth, capital outlay as a proportion of total expenditure is likely to rise to 14.4 percent from 13.9 percent. A large proportion of the capital allocations are for road, rail and metro infrastructure projects and should be growth positive on net relative to now spending. Second, the revenue measures are progressive, meaning the burden on low income earners has been relieved, while the burden on high income earners has been increased. This ought to mitigate some of the aggregate consolidation since those in the lower tail of the income distribution have higher propensities to consume.

Third, the new budget for the central government does not accommodate state budgets that will also probably be modestly expansionary. On the one hand, states have exceeded the fiscal consolidation targets (the central budget showed that states should get higher transfers than previously expected from the higher tax revenues). This implies a fiscal stimulus from the states this year and then a steady state for the 2017/18.

Financial Goals for the year 2016 to 2017

Although the budget deficit over Apr-Nov16 is 86% of the full-year target, we expect revenues to catch up over the next four months, but the downside risk of fiscal slippage in FY16/17 is low. Likewise, the collection of direct taxes also witness a seasonal strength during December and the growth of March. Direct tax revenue heart of the budget, indirect tax revenue: indirect tax revenue sub-heads running ahead of budgeted pace, indirect tax revenue: indirect tax revenue sub-heads running ahead of budge. This year, the share of indirect collections over overall tax revenues expected to cross direct receipts.





Revenues that are expected to rise from one-off sources However, the last IDS was terminated in September last year and is estimated to have provided a revenue windfall of INR 250bn (0.2% of GDP). The RBI will also distribute large dividends of INR 660bn (0.4% of GDP). Collections on different non-tax other like telecom range and divestment receipts will likewise swell the kitty however miss focuses. Short-term boost in revenues from demonetisation. Banks allege that only over 95% of the demonetised notes have been backed. If justified, 5% of the remaining can come from one-off dividend from changes in the balance sheet of the RBI (0.1-0.2% of GDP). This is sectional declaration scheme where the benefits will not directly be counted in next year. Bank recap and pay commission continue to be items in the expenditure side not extended to deviate from the estimates. It hits the 3.5% of GDP FY16/17 deficit target due to better-than-expected revenues and spending as per plan.

Conclusion

This paper examined the co-integration and cause effect between budget deficit and economic growth in India between the years, 1991 and 2016. Using empirical evidence on time-series, it has been found that although deficits in the budget can enhance economic growth during recessions by stimulating growth, chronic deficit creates enormous difficulties. Some of these are inflation, rising interest rates, debt servicing expenses and a lesser fiscal room to make productive investments. It was an important milestone when the FRBM Act came into force in 2003 to restore fiscal discipline and guarantee a long-term macro-economic stability. Nevertheless, temporary departures of the fiscal consolidation path had to be observed, at least during times of global and domestic economic stress, e.g., during the financial crisis of 2008 and after 2016. Policymakers should conduct a delicate balance between fiscal rectitude and spurring growth. Constant budget deficits may slow down the long-term development ambitions of India in case they are not controlled. Hence, this paper proposes a balanced fiscal stimulus that encourages growth- friendly government spending and the use of reasonable deficit reduction goals.

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