M.Com. (Applied Economics)

Semester IV

Public Economics

Broad Topic

The measurement and determinants of fiscal deficits

Part - II

Teacher

Nagendra Kumar Maurya

Department of Applied Economics

The determinants of Fiscal Deficit

In the previous audio lecture as well as PDF file, I have discussed the measurement aspect budget deficit and its different types in detail. In this note, I would like to focus upon the determinants of the fiscal deficit. The determinants of the fiscal deficit come from the interaction between macroeconomic factors and government sector along with other political and economic factors. Let us understand these factors which are explained as follows:

A. National Income Accounting Approach

In the case of closed economy

We will take the help of national income accounting framework. The following notations have their standard meaning. Y stands for national income, C for consumption expenditure, I for investment expenditure and G for government expenditure. On the other hand, S for savings and T for taxes. For the sake of simplicity we assume there are no transfer payments.

The expenditure side identity is $Y = C + I + G$

The income side identity is $Y = C + S + T$

In the case of equilibrium scenario, following holds true:

$$C + I + G = C + S + T$$

Which leads to $\mathbf{(I - S) = (G - T)}$

This is an important finding that in the closed economy, the budget deficit (not strictly fiscal deficit but you may take it as proxy of fiscal deficit) is result of gap in domestic investment and savings. If the investment is greater than the desirable savings then the gap must be met by the increase in government expenditure. The increase in

government expenditure will lead to deficit in the economy. Whether this deficit will be good or bad depends upon the relative size of investment, tax and government multiplier. So, the first determinant is mismatch between investment and savings.

In the case of open economy

Since, we all know that no country in this modern era is a closed economy. Every economy has economic relations with the foreign country. Under open economy approach, the fundamental framework defines the gross national output or product (GNP) Y_t as the aggregate of income derived from production of goods and services for private consumption (C_t), Private Investment (I_t), Government Expenditure on purchasing or procuring goods and services (G_t) and net income from abroad or net exports ($X_t - M_t$).The aggregate expenditure or demand side of GNP in the simple Keynesian identity of national income can be written as:

$$Y_t = C_t + I_t + G_t + (X_t - M_t)$$

While the supply side of GNP allocated for several purposes like consumption (C_t), savings (S_t), Taxes (T_t) can be written as:

$$Y_t = C_t + S_t + T_t$$

Rearrangements after equating above (1) and (2) equations with ignoring transfer payments will provide us equation (3) as:

$$C_t + I_t + G_t + (X_t - M_t) = C_t + S_t + T_t$$

$$\boldsymbol{(S_t - I_t) - (M_t - X_t) = (G_t - T_t)}$$

The above highlighted equation depicts that combined saving-investment gap (S_t - I_t) and the trade deficit (M_t – X_t) jointly determines (G_t – T_t). *This is again an important finding that in the case of open economy, saving-investment gap and trade deficit will cause budget deficit. This can be easily understood as the fall in planned savings to*

meet planned investment and payment of excess import over export have to be covered by increase in government expenditure, which causes budget deficit in the economy.

B. Other determinants

1. Revenue Buoyancy

The one obvious explanation of gap between revenue and expenditure i.e. fiscal deficit is shortfall of tax and non-tax revenue collections. Low buoyancy (buoyancy can also referred as elasticity although both are not exactly same but for the sake of simplicity you make read it as elasticity) of revenue sources is one of the determinants of the fiscal deficit. The buoyancy here means the responsiveness of the resources especially tax resources with reference to economic growth of the nation. If the degree of responsiveness is high, it means with the increase in economic growth, tax collections also go up faster than the economic growth and vice-versa. The developing countries like India suffer from poor tax and non-tax buoyancy. The reasons for poor buoyancy are: low per capita income, supply-side rigidities, poor tax infrastructure, lop-sided development, low level of industrialisaton.

2. Level of development:

Level of development is also an indication of persistent fiscal deficit in an economy. The developing countries have huge requirement of financial resources for the purpose of making investment in industries, employment creation, poverty eradication, infrastructure development and other sectors. However, revenue resources are not sufficient in these countries neither private sector is strong enough to come forward to take these development works. Therefore, government expenditure often goes past revenues creating deficit in the accounts.

3. Political reasons

Political factors also affect fiscal deficit. The politicians are mostly interested to remain in the power. They are always ready to compromise with the public finance

when it comes to their existence and power. These things are often more obscured and complex in a democratic setup where there is multilayered government like India. In such a set-up, central government, state governments and local governments can be ruled by different parties simultaneously. They often offer several freebies and various schemes to remain in the power for the repeated terms, which are not well thought off from the perspective of revenue-expenditure balance. Therefore, on account of these measures too, government expenditure tends to rise without adequate creation of productive resources and matching revenue resources, thus, causing deficit.