Bud Def & Est - HOTS & Applications

Q.1. Can a huge budgetary deficit cause bankruptcy of the government?

Ans. No, the government never goes bankrupt, no matter how large are its liabilities.

Q.2. Is deficit budget a sign of government inefficiency?

Ans. No, a deficit budget is not a sign of government inefficiency. Infact, budgetary deficit may be a planned strategy of the government during periods of depression when the government needs to increase expenditure. It is only when expenditure increases that there is an increase in AD which is required to combat depression.

Q.3. It is said that fiscal deficit is a reflection of fiscal indiscipline. How?

Ans. Fiscal deficit is a reflection of fiscal indiscipline. It is particularly true when fiscal deficit is incurred on account of non-development expenditure (like expenditure on freebies to garner votes during elections). Such expenditures only contribute to inflationary spiral in the country, leading to economic instability.

Q.4. Balanced budget is recommended as a useful policy instrument when the economy is close to the level of full employment. How?

Ans. Balanced budget causes a modest increase in the level of AD. Because: expenditure by the government raises AD by the same amount, while tax receipts reduce AD by 'MPC times' the tax receipts. A modest increase in AD would push the economy towards the point of full employment when it is marginally away from this point. [**Note:** Balanced budget (additional revenue being equal to additional expenditure) is a good strategy during periods of modest recession when aggregate demand needs a modest rise.]

Q.5. Explain the implications of fiscal deficit.

Ans. Two serious implications of fiscal deficit are as these:

- **i.** Fiscal deficit highlights the extent to which the government resorts to borrowing to cope with its expenditures. Higher borrowing implies higher burden of repayment of loans. As this burden cumulates year after year, net availability of resources (net of the accumulated past payments) for future generations tends to shrink. This retards the process of growth.

ii. Inflation is the other serious implication of fiscal deficit. Rising fiscal deficit to finance rising expenditure (on non-productive activities) generally causes a greater stress of demand on the existing flow of goods and services. Inflation is the obvious consequence in such a situation. It is bad as it widens the gulf between the rich and the poor. Also, inflation leads to a rise in the rate of interest. Accordingly, investment is reduced and GDP growth is impeded.

Q.6. "Governments across nations are too much worried about the term fiscal deficit". Do you think that fiscal deficit is necessarily inflationary in nature? Support your answer with valid reasons.

[*CBSE Sample Paper 2016*]

Ans. Fiscal deficit indicates 'borrowings' by the government. Borrowing from RBI is an important component of government borrowing. This increases money supply in the economy. Increase in money supply leads to increase in the general price level. A persistent increase in the general price level (over a period of time) leads to inflationary spiral. It is like wage-price spiral: wages catch prices and prices catch wages. This hinders the process of growth as it raises (i) the cost of raw material, (ii) the cost of credit for investment (the rate of interest), and (iii) the cost of labour (wage rate). However, fiscal deficit is not necessarily inflationary in nature. Keynes recommends deficit budget (fiscal deficit) as a key instrument to correct the state of depression. According to him, depression is that phase of economic activity when the level of investment is low owing to the low level of AD. Consequently, the level of output (and therefore, the level of income) remains low, and resources remain under-utilised. Unemployment becomes a serious problem. It is in such situations that deficit budget can serve as a useful policy instrument.

Deficit budget (fiscal deficit) raises the level of AD in two ways:

i. Directly by way of high government expenditure, and

ii. Indirectly by inducing greater (investment and consumption) expenditure by the people.