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Fiscal Challenges in Karnataka: Examining Budget Deficits and their Financing

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Abstract

This study examines Karnataka's fiscal challenges, focusing on budget deficits and their financing mechanisms. Budget deficits, arising when expenditures exceed revenues, demand efficient fiscal management and sustainable financing strategies. Through a temporal analysis, the study identifies trends in Karnataka's budget deficits and explores the primary financing sources utilized by the state government. A descriptive methodology is adopted, relying on secondary data sourced from the Reserve Bank of India (RBI). The study period covers FY 2004-05 to 2022-23 for analyzing fiscal indicator growth rates and FY 2004-05 to 2020-21 for Gross Fiscal Deficit financing strategies. This analysis sheds light on Karnataka's reliance on financing mechanisms such as market borrowings, loans from the center, and contributions from the National Small Savings Fund (NSSF). Findings reveal that market borrowings are the most preferred method for financing deficits in Karnataka and other states/UTs, accounting for a significant share of funding. However, this heavy reliance poses risks, including the crowding-out effect on private investment. The study emphasizes the need for reducing unproductive expenditures and prioritizing developmental investments that can generate sustainable revenue streams, ensuring fiscal stability and economic growth. By addressing deficit trends and financing strategies, this research contributes to public finance literature, offering valuable insights for policymakers seeking to balance fiscal responsibility with growth objectives.

Keywords: *Budget Deficits, Deficit Financing, Fiscal Management, Public Finance*

1. Introduction:

During the late 17th century, the British Government introduced the concept of a budget as a means to manage its finances during a period of financial strain following the English Civil War. This marked the first formal use of budgeting by the British Government. In India, the budget was first introduced during British colonial rule. James Wilson, the then Finance Minister of India, presented the first Indian budget on April 7, 1860. Following India’s independence in 1947, the first Union Budget was presented by R.K. ShanmughamChetty, the finance minister of independent India, on November 26, 1947. Presented amidst the upheaval of Partition, this budget covered seven and a half months, with the subsequent budget scheduled for April 1, 1948. Notably, this budget proposed that India and Pakistan share the same currency until September 1948.The budget, often referred to as an annual financial statement, outlines a nation’s estimated revenues and expenditures over a specific period. In India, the Union Budget is typically presented in the first week of February each year, reflecting the government's plans for allocating funds to various sectors, introducing policy changes, and revising tax structures. It provides insights into the country's financial health by analyzing surplus and deficit accounts. For many years, India has consistently maintained a deficit budget, working towards managing these deficits to support economic growth.

Like the Union Budget, individual states in India prepare and present their state budgets to finance state-level activities. While the Union Budget is governed by Article 112 of the Indian Constitution, state budgets are prepared under the provisions of Article 202. Karnataka's state budget is presented before both houses of its legislature, outlining the financial roadmap for the state.A government budget is categorized as either surplus or deficit based on the financial outcomes of the year. A surplus budget occurs when revenues exceed expenditures, while a deficit budget arises when expenditures surpass revenues. Deficits are further classified into three main types: fiscal deficit, revenue deficit, and primary deficit. These indicators are critical for assessing fiscal strength and understanding the economic health of a nation or state.Among these, the fiscal deficit is particularly significant in India due to its potential economic consequences, such as increased government debt, higher interest payments, and reduced private sector investmenta phenomenon known as the "crowding out effect." Historically, the lack of regulations around deficit financing led to a depletion of financial resources, forcing the government to rely heavily on borrowings to manage its budget shortfalls.India introduced the Fiscal Responsibility and Budget Management (FRBM) Act to address these challenges in 2003. This legal framework aims to control excessive spending and limit fiscal deficits to 3% of GDP. It also strives to eliminate revenue deficits, optimize tax revenue, and maintain a prudent level of total liabilities as a percentage of GDP, as outlined in the medium-term fiscal policy statement. The FRBM Act provides a set of rules for the central government to regulate its fiscal activities.

At the state level, Karnataka enacted the Karnataka Fiscal Responsibility Management (KFRM) Act in 2002 to address similar concerns. The KFRM Act incorporates 14 fiscal principles to guide the state in managing its revenue, expenditure, and borrowing practices. This framework is aimed at ensuring fiscal stability and promoting sustainable financial management.Karnataka faced significant fiscal challenges at the turn of the century, culminating in a severe deficit crisis in 2000. Opposition parties demanded transparency, prompting the state government to publish a white paper on state finances in March 2000. Following this, the government developed a Medium-Term Fiscal Plan for 2001–2005, focusing on achieving fiscal stability and sustainability. The plan included clear goals: eliminating revenue deficits, containing fiscal deficits to 3% of Gross State Domestic Product (GSDP), maintaining debt stock at prudent levels, and maximizing developmental expenditures.The KFRM Act formalized these objectives, establishing rules for deficit financing and setting targets to improve the state's financial management. Through these efforts, Karnataka has sought to balance fiscal responsibility with developmental goals, ensuring sustainable economic growth.

2. Need for the Study:

The major concern in India is the fiscal deficit which is considered as excess of total expenditure over total revenue due to its potential economic impact such as, it can lead to increased government debt, higher interest payments, and a crowding out effect of private investment. Analysing Karnataka’s data can reveal if the debt is sustainable and identify factors affecting it, and the impact of deficits on the state’s economic growth. The state of Karnataka must control its expenditure, the study can evaluate the effectiveness of different budget deficits in terms of cost, risk, and long-term impact. It is necessary to work on the impact of various budget deficits on the state’s economy because the major impact of crowding out of private investment results in the breakout of the stock market which is one of the pillars of the Indian economy. It is a need for any state to increase their capital expenditure which generates revenue and should have a minimal rate of revenue expenditure for running the state government.

3. Objectives of the Study:

1. To analyze the temporal and patterns of budget deficits in Karnataka.
2. To examine the sources of deficit financing.

4. Methodology:

The study adopts a descriptive approach and relies on secondary data available in the public domain. Relevant data and information are sourced from the Reserve Bank of India (RBI), specifically from the Handbook of Statistics on Indian States and State Finances: A Study of Budgets found in the RBI's annual publications. The study period spans from FY 2004-05 to 2022-23 for analyzing the growth rates of individual fiscal indicators and from FY 2004-05 to 2020-21 for examining the financing of the Gross Fiscal Deficit. Unless otherwise specified, all figures in this report are presented at current prices.

5. Data Review and Interpretation:

Temporal trends in select fiscal indicators of Karnataka State

The state of Karnataka is highly prudent when it comes to managing its finances. Karnataka was the first state to enact the Fiscal Responsibility Actin 2002, even before the enactment of FRBM 2003. The state is one of the first to achieve all the targets man dated by the FRBM and maintained a revenue surplus from 2004-05 to 2019-20. The temporal study in select fiscal indicators is only a study of Karnataka state from 2004 to 2023 (BE), where every year is considered and compared with the previousyear’sfiscalposition.Itisaperiodicalstudyof Karnatakastateforthesaidperiod,to arrive at a solution and to make major recommendations for any amendments required to maintain the state’s fiscal position as per the prescribed limit in the act. The temporal study is restricted to fiscal indicators like fiscal deficit, revenue deficit, primary deficit, capital expenditure, capital outlay, interest payments and outstanding liabilities which are all compared in their amount in rupees.

Table: 1. FiscalIndicators of Karnataka

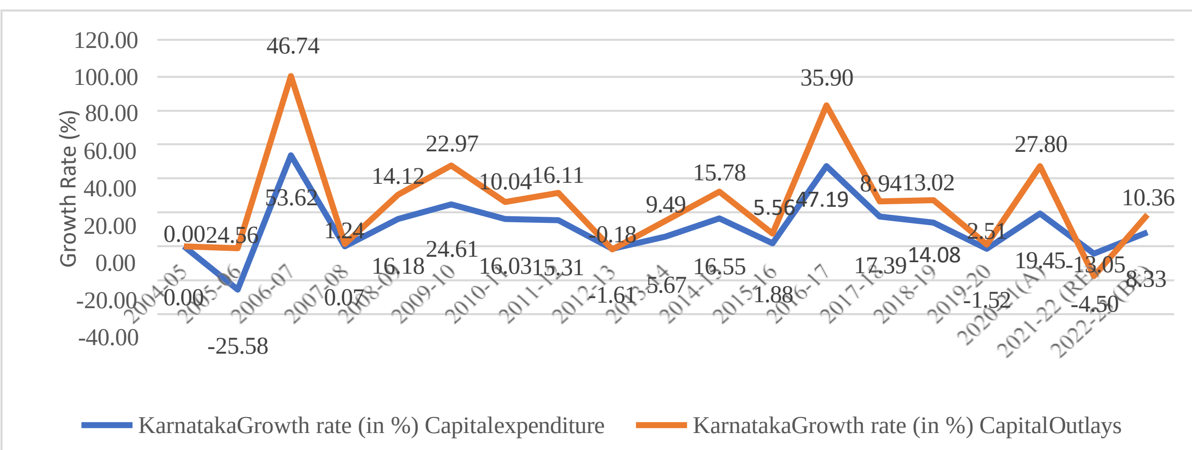
(Rs. In Crore)

Years	Fiscal Deficit	Revenue Deficit	Primary Deficit	Capital Expenditure	Capital Outlays	Interest Payments	Outstanding Liabilities
2004-05	3600	-1638	-194	9315	4674	3794	44345
2005-06	3687	-2311	-78	6932	5822	3765	49587
2006-07	4688	-4152	452	10649	8543	4236	58079
2007-08	5331	-3776	826	10656	8649	4506	60555
2008-09	8732	-1631	4200	12380	9870	4532	65219
2009-10	10874	-1619	5661	15427	12137	5213	84534
2010-11	10688	-4172	5047	17900	13355	5641	93447
2011-12	12300	-4691	6239	20641	15506	6062	93447
2012-13	14507	-1883	7674	20308	15478	6833	112667
2013-14	17092	-353	9255	21459	16947	7837	138976
2014-15	19577	-528	10173	25011	19622	9404	158370
2015-16	19169	-1789	8422	25480	20713	10746	185698
2016-17	28665	-1293	16632	37505	28150	12033	211169
2017-18	31101	-4517	17171	44028	30667	13930	245951
2018-19	38442	-679	23019	50229	34659	15423	286329
2019-20	38166	-1185	19646	49468	35529	18519	338666
2020-21	67098	19338	45177	59091	45406	21920	421504
2021-22 (RE)	48470	6235	21309	56430	39482	27161	473438
2022-23 (BE)	61564	14699	32170	61133	43573	29395	535157

Source: RBI State Finance: A Study of Budgets (2004-05 to 2022-23)

The above table 1 shows the total values of different fiscal indicators such as Fiscal deficit, Revenue deficit, Primary deficit, Capital expenditure, Capital outlays, interest payments, and Outstanding liabilities. All these indicators give a clear picture of the country's economic conditions and the fiscal position of every state. These indicators are periodically examined to know the fiscal position so that if any difficulties occur they can be easily identified and managed through regulations by interpreting the said acts such FRBM Act 2003 for the country's economy and KFRM Act 2002 for the state of Karnataka in particular. If we consider the data from 2004 to 2023 (BE) the Karnataka state had Rs.3600 crores of fiscal deficit in 2004-05 which gradually increased to reach Rs. 61564 crores in 2023(BE) [Table 1]. Similarly, changes have occurred in all other indicators viz., Revenue Deficit (RD), Primary Deficit (PD), Capital Expenditure (CE), Capital Outlays (CO), Interest Payments (IP), and Outstanding Liabilities (OL). The RD of the state in the year 2004-05 was Rs. -1638 crores which means the state had a Revenue surplus in that particular year and the state had maintained a revenue surplus up to 2019-20 (pre-Covid-19 period). Concerning primary deficit, the state government had a surplus balance which means the interest payments by the government were stable for the years 2004-05 and 2005-06. The state government increased its capital expenditure and capital outlays from 2004-05 to 2022-23 (BE) in nominal terms. If we investigate the thriving changes in outstanding liabilities and interest payments by the state government, it shows that the government has increased its borrowings to blow up its state activities. The above table clearly states that the fiscal deficit has increased 17 times, outstanding liabilities increased 12 times and interest payments have increased by 7 times from 2004-05 to 2022-23.

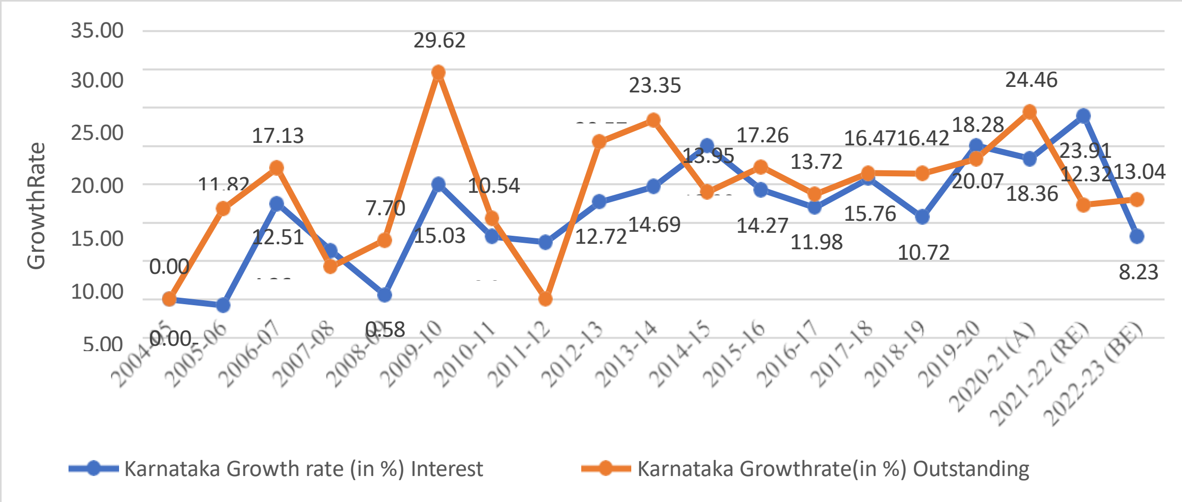
Figure 1: Growth of capital expenditure and capital outlay



Source: RBI State Finance: A Study of Budgets

Growth of Capital Expenditure: Figure 3.1 depicts the growth rate of Karnataka concerning its capital expenditure (capex) and capital outlays. The state's capital expenditure account has shown a growth rate ranging from -25.58% to 46.84% from 2004-05 to 2022-23 (BE). On average, the state has maintained its growth rate of capital expenditure account around 12.40%. The state's capital outlays which means the state's investment in the creation of assets or improvement of infrastructure have changed year-on-year; it has registered an average growth rate of around 13.99% since 2004-05.

Figure 2: Growth of Interest Payments and Total Liabilities



Source: RBI State Finance: A Study of Budgets(variousyears)

Interest payments and total liabilities: Figure 2 depicts the growth rate of Karnataka concerning Interest Payments (IP) and Outstanding Liabilities (OL). The increase in interest payments shows that the state government has increased its borrowings year on year to fill the gap between receipts and expenditures. In the year 2005-06, the growth rate of interest payments was -0.76% which positively increased and reached 23.91% in 2021-22(RE) due to more borrowings by the state government. Due to COVID-19 in 2019-20, the state government was facing difficulty in maintaining the balance between revenue receipts and revenue expenditure, where it went for borrowings and increased its liabilities which indirectly increased its interest payments. If we investigate the growth rate of outstanding liabilities of the state, it was highest in the year 2009-10 at 29.62% due to the effect of global recession which affected the entire world's economy in 2008-09. The figure also shows that the state's outstanding liabilities growth rate is more than that of its interest payments.

Table:2. GrowthRate(%)of BudgetDeficitsinKarnataka

Years	FiscalDeficit (FD)	Revenue Deficit (RD)	PrimaryDeficit (PD)
2004-05	**-**	**-**	**-**
2005-06	**2.42**	**41.09**	**-60**
2006-07	**27.15**	**79.66**	**-679**

2007-08	**13.72**	**-9.06**	**83**
2008-09	**63.8**	**-56.81**	**408**
2009-10	**24.53**	**-0.74**	**35**
2010-11	**-1.71**	**157.69**	**-11**
2011-12	**15.08**	**12.44**	**24**
2012-13	**17.94**	**-59.86**	**23**
2013-14	**17.82**	**-81.25**	**21**
2014-15	**14.54**	**49.58**	**10**
2015-16	**-2.08**	**238.83**	**-17**
2016-17	**49.54**	**-27.72**	**97**
2017-18	**8.5**	**249.34**	**3**
2018-19	**23.6**	**-84.97**	**34**
2019-20	**-0.72**	**74.52**	**-15**
2020-21	**75.81**	**-1732**	**130**
2021-22 (RE)	**-27.76**	**-67.76**	**-53**
2022-23 (BE)	**27.01**	**135.75**	**51**

Source: RBI State Finance: A Study of Budgets (2004-05 to 2022-23)

Growth of Budget Deficits: Table 2 explains the % growth rate of fiscal deficit (FD), Revenue Deficit (RD), and Primary Deficit (PD). It indicates that the growth of the state's fiscal deficit ranges from -27.76 percent (lowest) in 2021-22 to 75.81 percent (highest) in 2020-21 with some change in the degree of growth in between the periods. It is clear from the above table that the growth of the state's fiscal deficit was higher in the years 2008-09, 2016-17, and 2020- 21 which is 63.80%, 49.54%, and 75.81% respectively. On average, the state fiscal deficit has grown around 19.40% from 2004-05 to 2022-23 (BE).

The RD shows the negative annual average growth rate of Karnataka to the tune of around -60.06% which is a positive aspect of the state's financing. The average negative growth rate of RD states that Karnataka has maintained a revenue surplus over the years. If we observe the changes in the PD account, the state has an average growth rate of around 5% which indicates that there is stability concerning interest payments. The lowest average growth rate of Karnataka among these three indicators is PD with only 5%.

Table: 3. AnnualAverageGrowthRateandCompoundAnnualGrowth Rate Fiscal Indicators

Fiscal indicators	AAGR		CAGR	
	Karnataka	AllStates and UT's	Karnataka	All States and UT's
FiscalDeficit	19.4	15	17.09	12.31
Revenue Deficit	-60.06	-97.68	NA	4.75
PrimaryDeficit	4.67	-16.14	NA	17.9
Interest Payments	0.12	0.1	12.05	9.77
Capital Expenditure	12.4	12.69	11.02	11.89
Capital Outlays	13.99	15.67	13.2	14.94
Outstanding Liabilities	15.05	11.78	14.84	11.74

Source: RBI State Finance: AStudy of Budgets(2004-05 to 2022-23)

From Table 3, it is understood that the AAGR of the fiscal deficit of Karnataka is about 19.40% which is more than 15.00% of All States/UTs. The negative growth of the Revenue deficit indicates a Revenue surplus which is -60.06% of Karnataka more than that of All States/UTs having -97.68%. All States/UTs maintain surplus primary accounts having a negative growth rate of -16.14% whereas Karnataka state has a positive growth rate of 4.61%. The CAGR of the fiscal deficit of Karnataka state is about 17.09% which is higher than 12.31% of All States/UTs. The CAGR of indicators like Interest payments and outstanding liabilities of Karnataka state is 12.05% and 14.84% which is comparatively much higher than that of All States/UTs having 9.77% and 11.74%. To conclude, the growth rate of Karnataka indicates higher obligations towards each indicator when compared to all other states and UTs except the Revenue deficit which is Performing comparatively better than all other states and UTs.

II **Financing of Fiscal Deficits**

Table: 4. FinancingofGrossFiscalDeficit(Rs.in Crore)

Year	States	Market Borrowings	Loansfrom Centre	Small Savings/ NSSF	Others	GFD

2004-05	**Karnataka**	**2116**	**-1206**	**3741**	**-1050**	**3600**
	AllStates	**34559**	**-11804**	**67924**	**18578**	**109257**
2005-06	**Karnataka**	**166**	**609**	**3969**	**1148**	**5892**
	AllStates	**15305**	**-44**	**73815**	**34954**	**124030**
2006-07	**Karnataka**	**-233**	**-83**	**2478**	**4025**	**6187**
	AllStates	**13083**	**-8887**	**56023**	**33615**	**93834**
2007-08	**Karnataka**	**287**	**357**	**209**	**2292**	**3145**
	AllStates	**53925**	**-933**	**5853**	**30020**	**88865**
2008-09	**Karnataka**	**6583**	**135**	**-164**	**5768**	**12322**
	AllStates	**104041**	**-761**	**1479**	**38789**	**143548**
2009-10	**Karnataka**	**4950**	**210**	**250**	**7090**	**12500**
	AllStates	**112650**	**-1700**	**24160**	**46010**	**181120**
2010-11	**Karnataka**	**1040**	**610**	**1840**	**4640**	**8130**
	AllStates	**88780**	**710**	**38630**	**48190**	**176310**
2011-12	**Karnataka**	**6210**	**470**	**-840**	**7900**	**13740**
	AllStates	**135400**	**180**	**-8060**	**57150**	**184670**
2012-13	**Karnataka**	**9150**	**650**	**-520**	**4530**	**13810**
	AllStates	**146250**	**1730**	**-170**	**70750**	**218560**
2013-14	**Karnataka**	**13410**	**460**	**-340**	**7690**	**21220**
	AllStates	**163570**	**600**	**2560**	**63020**	**229750**
2014-15	**Karnataka**	**16090**	**590**	**440**	**9360**	**26480**
	AllStates	**206440**	**960**	**24000**	**78070**	**309470**
2015-16	**Karnataka**	**14910**	**320**	**1560**	**1250**	**18040**
	AllStates	**258370**	**1040**	**27100**	**164780**	**451290**
2016-17	**Karnataka**	**24030**	**790**	**-1570**	**12660**	**35910**
	AllStates	**351670**	**5230**	**-31990**	**222980**	**547890**
2017-18	**Karnataka**	**17348**	**761**	**-1573**	**3866**	**20403**
	AllStates	**344616**	**4634**	**-32444**	**110255**	**427061**

Source: RBI State Finance: A Study of Budgets (2004-05 to 2022-23)

Table: 5. Financing of fiscal deficit(in%)

Karnataka					AllStates/UTs			
Year	Market Borrowing	Loans From Centre	Small Savings/ NSSF	Others	Market Borrowinggs	Loans From Centre	Small Savings/ NSSF	Others
2004-05	58.8	-33.5	103.9	-29.2	31.63	-10.80	62.17	17.00
2005-06	2.82	10.34	67.36	19.48	12.34	-0.04	59.51	28.18
2006-07	-3.77	-1.34	40.05	65.06	13.94	-9.47	59.70	35.82
2007-08	9.13	11.35	6.65	72.88	60.68	-1.05	6.59	33.78
2008-09	53.42	1.10	-1.33	46.81	72.48	-0.53	1.03	27.02
2009-10	39.60	1.68	2.00	56.72	62.20	-0.94	13.34	25.40
2010-11	12.79	7.50	22.63	57.07	50.35	0.40	21.91	27.33
2011-12	45.20	3.42	-6.11	57.50	73.32	0.10	-4.36	30.95
2012-13	66.26	4.71	-3.77	32.80	66.92	0.79	-0.08	32.37
2013-14	63.20	2.17	-1.60	36.24	71.19	0.26	1.11	27.43
2014-15	60.76	2.23	1.66	35.35	66.71	0.31	7.76	25.23
2015-16	82.65	1.77	8.65	6.93	57.25	0.23	6.01	36.51
2016-17	66.92	2.20	-4.37	35.25	64.19	0.95	-5.84	40.70
2017-18	85.03	3.73	-7.71	18.95	80.69	1.09	-7.60	25.82
2018-19	103.18	0.33	-5.11	1.61	84.02	1.94	-7.56	21.60
2019-20	11.32	-0.20	-0.43	89.31	58.32	1.28	-3.78	44.18
2020-21	82.39	16.92	-2.17	2.86	78.83	16.12	-3.71	8.76

Source: RBI State Finance: A Study of Budgets (2004-05 to 2022-23)

The table highlights the methods used by governments, including Karnataka's state government and the Union Government, to finance fiscal deficits, with options such as Market Borrowings, Loans from the Centre, National Small Savings Fund (NSSF), and others (e.g., special securities to NSSF, loans from institutions like LIC, NABARD, NCDC, SBI, provident funds, reserve funds, deposits, and advances). From 2004-05 to 2006-07, all states and UTs primarily relied on NSSF, contributing 62.17%, 59.51%, and 59.70%, respectively, while Karnataka sourced 103.9% and 67.36% of its funds from NSSF during 2004-05 and 2005-06. However, from 2009-10 to 2011-12, Karnataka shifted to other sources (56.72%, 57.07%, and 57.50%), whereas other states and UTs leaned towards Market Borrowings (62.20%, 50.35%, and 73.32%). Post this period, both Karnataka and other states/UTs relied significantly on Market Borrowings, except in 2019-20 when the global COVID-19 pandemic forced Karnataka to turn to alternative sources. On average, Karnataka's fiscal deficits are funded by 49.4% through Market Borrowings, followed by 35.6% from other sources, 13% from NSSF, and 2% from Loans from the Centre. Similarly, all states and UTs finance deficits majorly through Market Borrowings (59.12%), followed by 28.71% from other sources, 12.19% from NSSF, and a minimal 0.04% from Loans from the Centre. Despite the crowding-out effect of private investment, Market Borrowings remain the most preferred source for financing deficits. To address this reliance, it is recommended that governments reduce unproductive expenditures and prioritize developmental investments that generate revenue, enabling better fiscal management with reduced dependence on borrowings.

6.Major Findings

1. During COVID-19, the entire world economy was badly hit and it affected every sector at a grassroots level, and the same effect in Karnataka led to a downfall in economic activities. From then on, the government, to recover from the COVID effect, started modifying the tax base to generate revenue, allowing private investment to grow the public infrastructure, etc.
2. The major finding in the report is that during post-COVID-19, the state government of Karnataka is facing a revenue deficit. Before the COVID-19 effect, it was maintaining a revenue surplus account without any difficulties.
3. Presently, the estimated fiscal deficit of Karnataka state for 2023-24 is around 2.6% which is below the threshold limit of 3% to GSDP mentioned in the KFRM Act, 2002. It means the state is allowed to raise loans from sources to improve its infrastructure. From around 4% during Covid-19, it has reduced to 2.6% of the fiscal deficit, because of the major initiatives taken at the subnational level and some implications at the union level.
4. In the comparison made, the state government of Karnataka is performing better than other states and UTs in different indicators at a certain level.
5. The performance of Karnataka is measured by its GSDP, which is the third largest economy in India. The proportion of fiscal deficit to GSDP of Karnataka state is on average 2.16% as per the findings which is less than 2.69% of all other states and UTs. It indicates the progress of Karnataka in maintaining its deficit proportion to reduce the burden of interest payments, borrowings, etc.
6. The capital expenditure by the government plays a vital role in attracting private investments because once the government starts funding for developing public infrastructure which ensures ease of doing business, more private players get attracted to the facilities available and start establishing their units which automatically generate revenue for the government and increase the standard of living.
7. The government of Karnataka has a lesser priority on spending capital formation. The state government of Karnataka should consider more on its capital formation by increasing its capital expenditure and by reducing funding on its committed expenditures that is

revenue expenditures.

8. The magnitude of interest payments and total liabilities is significantly higher for All States/UTs as compared to Karnataka.

9. The government of states and UTs as well as the Government of India should reduce its outstanding liabilities which is a major reason for the burden of interest payments to the borrowed funds. If it is necessary to raise funds from outside such borrowings should be effectively utilized for capital expenditures which can generate revenues to the government to meet the payments raised from outside sources.

7.Recommendations

- ✓ The state government of Karnataka has had a 2.6% fiscal deficit which is below the limit of 3% and is allowed to extend its borrowings of 0.40% to improve its infrastructure as per the recommendations of the finance commission. So, the state government must focus on increasing its Capital expenditure (capex).
- ✓ It is required to reduce the portion of committed expenditure which results in draining out revenues that are claiming funds even from capital receipts.
- ✓ Increase the investment in developing public infrastructure which is a major source of generating revenues and increases the pool of private investments into the states.
- ✓ The government should reduce its unproductive expenditures by taking various initiatives and focusing on investing in developmental activities that generate revenue and through this, the state government or union government can manage its deficits without depending more on other sources.
- ✓ The union government should adhere to the FRBM Act 2003 regulations and recommendations to manage its government budget and states should follow their respective guidelines to maintain its budget deficits.

8.Conclusion

Deficit financing refers to the process by which a government funds a deficit budget through borrowings from internal or external sources, or as a last resort, by printing currency. While this method can help bridge budgetary gaps, many economists argue that it raises real interest rates, reduces national savings and investments, and slows down capital formation and economic growth. Additionally, it shifts the financial burden of government expenditures from the current generation to future taxpayers. On the positive side, government deficits can stimulate economic stability and prevent severe recessions by enabling increased government spending, which can foster steady economic growth near the economy’s potential. This stability can encourage private and foreign investment by creating a favorable economic environment. Expanding credit to reduce interest rates can further stimulate recovery, potentially increasing fiscal revenues and reducing deficits. However, the size of the deficit and the taxation methods used are critical factors in determining a government's economic status. Large budget deficits often lead to a "crowding-out" effect, where government borrowing absorbs financial resources, leaving fewer funds available for private investment. While this effect is widely accepted, the exact reduction in investment and the subsequent impact on the welfare of future generations remain difficult to quantify accurately.

In the context of Karnataka and other Indian states, Market Borrowings are the most commonly used method to finance budget deficits. However, heavy reliance on this method risks exacerbating the crowding-out effect. To address this, governments should reduce unproductive expenditures and prioritize investments in developmental activities that generate revenue. Such strategies would help manage deficits more sustainably and reduce dependence on borrowing from market sources.

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