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The Impact of Fiscal Deficit on Inflation and Economic Growth: Evidence and Policy Implications

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Abstract: This study examines the relationship between fiscal deficit, inflation, and economic growth, with a focus on how sustained government borrowing shapes short- and medium-run macroeconomic outcomes. Fiscal deficit, the gap between government expenditure and revenue, is a central instrument of countercyclical policy, yet its financing carries consequences for price stability and the trajectory of output. Using a combination of theoretical review and time-series macroeconomic data (fiscal deficit, consumer price inflation, and real GDP growth) spanning twelve fiscal years, this paper investigates whether higher fiscal deficits are systematically associated with higher inflation and altered growth performance. Correlation analysis indicates a moderate positive association between fiscal deficit and inflation and a stronger negative association between fiscal deficit and contemporaneous GDP growth, although the latter is substantially influenced by the countercyclical deficit spending observed during the COVID-19 pandemic. The findings suggest that the effect of fiscal deficit on macroeconomic stability is non-linear and contingent on the composition of expenditure, the stage of the business cycle, and the credibility of monetary policy. The paper concludes with policy recommendations emphasising fiscal consolidation anchored in capital expenditure, rule-based fiscal frameworks, and coordinated monetary-fiscal policy to balance growth and price stability objectives.

Keywords: fiscal deficit; inflation; economic growth; fiscal policy; macroeconomic stability; public debt

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1. Introduction

Fiscal deficit occurs when a government's total expenditure exceeds its total revenue in a given fiscal year, requiring the shortfall to be financed through domestic or external borrowing. As a policy instrument, deficit spending allows governments to stimulate aggregate demand during downturns, finance infrastructure, and provide social protection. However, persistent and large fiscal deficits raise long-standing concerns among economists regarding their implications for inflation, interest rates, exchange rate stability, and the sustainability of public debt.

The relationship between fiscal deficit and macroeconomic performance has been debated across competing theoretical traditions. Keynesian economists view deficit financing as a legitimate and often necessary tool to counteract insufficient private demand, particularly during recessions, arguing that the resulting output gains outweigh short-run price pressures (Blanchard, 2019). In contrast, monetarist and neoclassical perspectives caution that deficits financed through money creation or excessive borrowing can generate demand-pull inflation, crowd out private investment through higher interest rates, and undermine long-run growth (Sargent & Wallace, 1981). The

Ricardian equivalence hypothesis further complicates the picture by suggesting that rational agents may anticipate future tax liabilities arising from current deficits and adjust their saving behaviour accordingly, thereby muting the expansionary effect of deficit spending (Barro, 1989).

Emerging market economies, including India, offer a particularly instructive setting for this debate because they have experienced pronounced swings in fiscal deficit alongside significant inflation volatility and variable growth performance over the past decade. The global financial crisis, followed by a period of fiscal consolidation, and then the extraordinary countercyclical deficit spending triggered by the COVID-19 pandemic, together provide a natural experiment for observing how the fiscal deficit–inflation–growth relationship behaves under different macroeconomic regimes.

This paper contributes to the literature in three ways. First, it synthesises the principal theoretical channels through which fiscal deficit transmits to inflation and growth. Second, it presents an empirical illustration using twelve years of macroeconomic data, summarised in a table and visualised through two original figures depicting trends and bivariate associations. Third, it derives policy implications relevant to fiscal consolidation strategies that seek to preserve growth while containing inflationary risk. The remainder of the paper is organised as follows: Section 2 reviews the relevant literature; Section 3 outlines the theoretical framework; Section 4 describes the data and methodology; Section 5 presents results; Section 6 discusses the findings; Section 7 offers policy recommendations; and Section 8 concludes.

2. Literature Review

A substantial body of empirical literature has examined the fiscal deficit–inflation nexus. Classical monetary theory, rooted in the quantity theory of money, predicts that deficits financed by money creation raise the price level, as articulated in the influential 'unpleasant monetarist arithmetic' framework of Sargent and Wallace (1981), which showed that even deficits financed by bonds today can generate future inflation if debt accumulation eventually forces monetisation. Catão and Terrones (2005) found a robust positive relationship between fiscal deficits and inflation in developing economies, though the relationship was statistically weak or absent among advanced economies with independent central banks and low average inflation, suggesting that institutional context conditions the strength of the transmission mechanism.

On the growth dimension, the literature is similarly divided. Proponents of expansionary fiscal policy argue that deficit-financed public investment can crowd in private investment by improving infrastructure and raising aggregate demand during periods of economic slack (Blanchard, 2019). Conversely, Reinhart and Rogoff (2010) argued that public debt levels beyond a critical threshold are associated with materially lower average growth rates, although subsequent research has questioned the robustness of a fixed threshold and emphasised that the debt–growth relationship is non-linear and context-dependent (Herndon, Ash, & Pollin, 2014).

In the Indian context, studies by the Reserve Bank of India and independent researchers have generally found that fiscal deficit exerts an inflationary influence primarily through its effect on aggregate demand and money supply growth, while its effect on GDP growth depends heavily on whether the deficit finances capital expenditure (which has a growth multiplier) or revenue expenditure such as subsidies (which has a comparatively lower multiplier) (Ministry of Finance, Government of India, 2024). The Fiscal Responsibility and Budget Management framework, introduced in 2003 and subsequently revised following the recommendations of the N.K. Singh Committee, reflects an institutional attempt to balance the stabilising role of deficit spending against the risks of fiscal dominance and inflationary financing.

Taken together, the literature suggests that the fiscal deficit–inflation–growth relationship is neither uniformly positive nor negative; rather, it is mediated by the composition of expenditure, the state of monetary policy independence, the credibility of fiscal rules, and the phase of the business cycle in which the deficit occurs.

International evidence offers additional nuance. Studies of advanced economies with independent central banks and well-anchored inflation expectations, such as the United States, Japan, and members of the Eurozone, generally find a weak or statistically insignificant contemporaneous link between fiscal deficits and inflation, particularly during periods of demand deficiency such as the post-2008 global financial crisis, when large deficits coexisted with historically low inflation (Blanchard, 2019). By contrast, emerging and developing economies with shallower financial markets, greater reliance on central bank financing, and less credible monetary institutions tend to exhibit a stronger and more immediate pass-through from deficits to inflation, since their governments have fewer alternative financing instruments and are more prone to monetise deficits directly (Catão & Terrones, 2005). This asymmetry underscores that institutional quality, including central bank independence, exchange rate regime, and the depth of domestic bond markets, is itself a key determinant of how costly a given fiscal deficit will be in inflationary terms, and helps explain why identical deficit ratios can produce very different macroeconomic outcomes across countries.

3. Theoretical Framework

Three principal channels link fiscal deficit to inflation and growth. First, the aggregate demand channel: deficit spending raises disposable income and government consumption, increasing aggregate demand; if the economy is operating near full capacity, this manifests as demand-pull inflation, whereas in a slack economy it primarily raises output. Second, the monetary financing channel: where deficits are financed through central bank purchases of government debt (monetisation) rather than market borrowing, money supply growth accelerates, directly feeding into inflation through the quantity-theory mechanism. Third, the crowding-out channel: government borrowing from domestic financial markets can raise real interest rates, discouraging private investment and thereby dampening medium-term growth, even as it may boost short-run demand.

A fourth, more subtle channel operates through expectations: if economic agents perceive persistent deficits as unsustainable, they may anticipate future inflation or taxation, adjusting wage demands, pricing behaviour, and saving patterns in ways that can either validate or offset the initial fiscal impulse (Barro, 1989). These channels are not mutually exclusive, and their relative strength depends on the credibility of the monetary authority, the openness of the capital account, the state of the business cycle, and whether deficit financing is directed toward productive capital formation or current consumption.

4. Data and Methodology

This study adopts a descriptive and correlational empirical approach using annual macroeconomic time-series data for the fiscal deficit (as a percentage of GDP), consumer price inflation (CPI, year-on-year percentage change), and real GDP growth rate, covering twelve fiscal years from 2013-14 to 2024-25. Data were compiled from Union Budget documents and the Macro-Economic Framework Statements of the Ministry of Finance, Government of India, the Reserve Bank of India's Handbook of Statistics, and cross-checked against World Bank national accounts data (Ministry of Finance, Government of India, 2024; Reserve Bank of India, 2024; World Bank, 2024).

The analysis proceeds in two steps. First, the three series are plotted jointly over time to visually identify co-movements and structural breaks, most notably the fiscal and macroeconomic disruption caused by the COVID-19 pandemic in fiscal year 2020-21. Second, Pearson correlation coefficients are computed between fiscal deficit and inflation, and between fiscal deficit and GDP growth, accompanied by simple linear trend lines, to provide an initial, descriptive indication of the strength and direction of association. It should be noted that correlation analysis of this kind does not establish causality; the relationships are shaped by simultaneous feedback (for example, low growth years mechanically raise the deficit-to-GDP ratio through a shrinking denominator, a phenomenon distinct from deficits causing low growth) and by exogenous shocks such as the

pandemic. The analysis is therefore intended as an illustrative empirical entry point rather than a definitive causal test, and results should be interpreted with appropriate caution.

5. Results

Table 1 presents the compiled annual data on fiscal deficit, CPI inflation, and real GDP growth for India across the twelve-year study period.

Table 1. Fiscal Deficit, Inflation and GDP Growth (India, FY2013-14 to FY2024-25)

Fiscal Year	Fiscal Deficit (% of GDP)	CPI Inflation (%)	Real GDP Growth (%)
2013-14	4.5	9.4	6.4
2014-15	4.1	5.9	7.4
2015-16	3.9	4.9	8.0
2016-17	3.5	4.5	8.3
2017-18	3.5	3.6	6.8
2018-19	3.4	3.4	6.5
2019-20	4.6	4.8	3.9
2020-21	9.2	6.2	-5.8
2021-22	6.7	5.5	9.1
2022-23	6.4	6.7	7.2
2023-24	5.6	5.4	8.2
2024-25	4.8	4.9	6.4

Note. Fiscal deficit is expressed as a percentage of nominal GDP; CPI = Consumer Price Index (year-on-year percentage change); GDP growth is measured in real (constant-price) terms. Compiled from Ministry of Finance (2024), Reserve Bank of India (2024), and World Bank (2024).

Figure 1 visualises the three series jointly. The fiscal deficit narrowed steadily from 4.5% of GDP in 2013-14 to 3.4% in 2018-19, alongside a corresponding disinflation from 9.4% to 3.4% CPI inflation, consistent with the theoretical prediction that fiscal consolidation supports price stability. The deficit then rose sharply to 9.2% of GDP in 2020-21 as the government undertook large-scale countercyclical spending in response to the COVID-19 pandemic, a year in which real GDP contracted by 5.8%. The subsequent rebound to 9.1% growth in 2021-22 occurred alongside a still-elevated but declining fiscal deficit, illustrating the lagged and asymmetric nature of the deficit-growth relationship around large shocks.

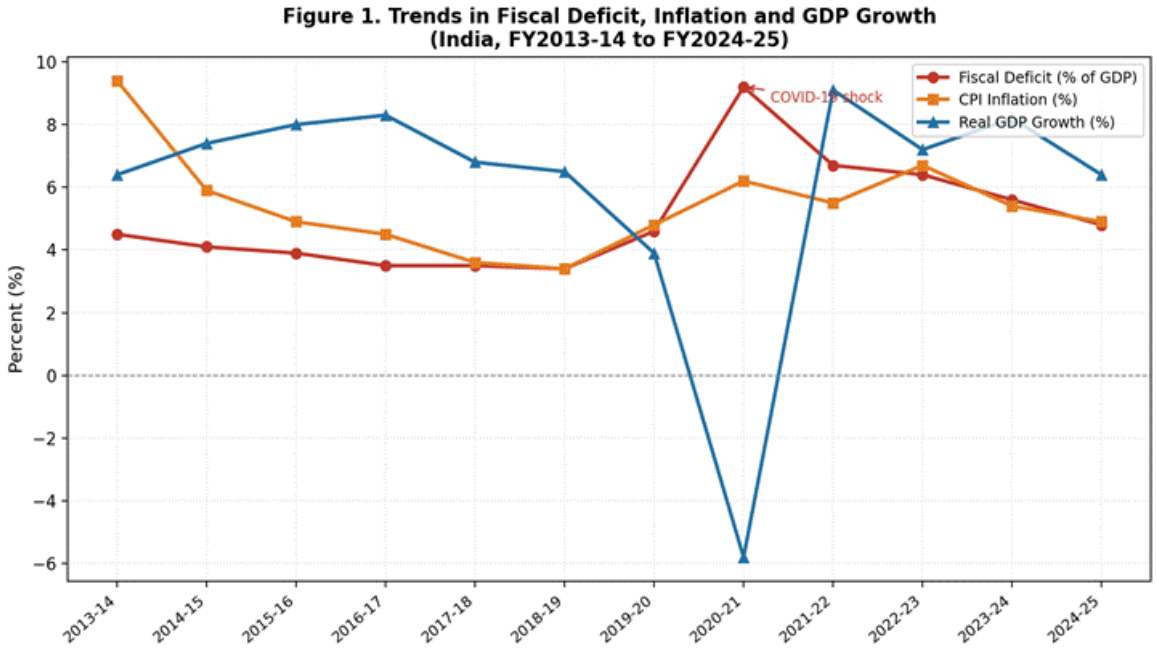
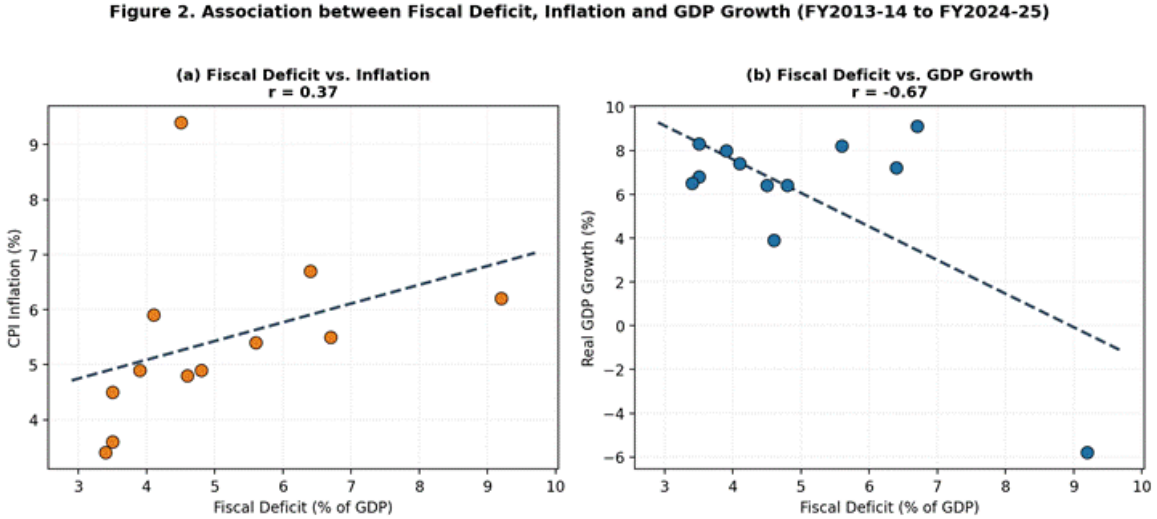


Figure 2 presents bivariate scatter plots with fitted linear trends. Panel (a) shows a moderate positive correlation between fiscal deficit and CPI inflation (r = 0.37), indicating that years of higher deficit tend to coincide with somewhat higher inflation, though the relationship is not strong enough to imply a mechanical one-to-one pass-through. Panel (b) shows a stronger negative correlation between fiscal deficit and real GDP growth (r = −0.67); however, this figure is heavily influenced by the pandemic-year outlier (2020-21), when a historically large deficit coincided with a historically sharp contraction driven by an exogenous public-health shock rather than by fiscal policy itself. When this outlier is set aside, the deficit–growth relationship in the remaining years is comparatively weak, underscoring that the raw correlation should not be read as evidence that deficits cause slower growth in normal times.



6. Discussion

The empirical patterns are broadly consistent with the theoretical channels discussed in Section 3. The steady fiscal consolidation between 2013-14 and 2018-19 coincided with disinflation, supporting the view that reduced government borrowing eases demand-side price pressure and contributes to macroeconomic stability. The sharp deficit expansion in 2020-21 illustrates the aggregate demand and monetary financing channels operating simultaneously: extraordinary fiscal support, complemented by accommodative monetary policy, helped cushion the contraction in output but was followed by elevated inflation in 2021-22 and 2022-23, a period marked also by

global commodity price shocks that make it difficult to attribute inflation solely to domestic fiscal policy.

The negative correlation between fiscal deficit and GDP growth should not be interpreted as straightforward evidence that deficits harm growth. Rather, it reflects the reality that fiscal deficits often rise during periods of low growth precisely because governments deploy countercyclical spending and because a shrinking or slow-growing GDP denominator mechanically inflates the deficit-to-GDP ratio. This reverse causality is a well-recognised identification challenge in the literature (Reinhart & Rogoff, 2010) and reinforces the importance of examining the composition of the deficit, whether it finances capital formation or current consumption, rather than its magnitude alone.

An important nuance evident in the Indian data is the post-pandemic emphasis on capital expenditure within the overall deficit, with capital spending rising as a share of GDP even as the headline deficit has been consolidated toward the medium-term target. This composition effect helps explain why India achieved robust growth (7-8% range) in 2022-23 through 2023-24 despite still-elevated deficits, consistent with the view that deficits directed toward productive investment carry a different growth signature than those directed toward subsidies or current consumption (Ministry of Finance, Government of India, 2024).

7. Policy Recommendations

Based on the theoretical review and empirical patterns discussed above, four policy directions are recommended. First, fiscal consolidation should proceed along a credible, rule-based glide path rather than abrupt adjustment, to avoid destabilising growth while steadily reducing inflationary and debt-sustainability risks. Second, the composition of the deficit matters: prioritising capital expenditure over current or subsidy-driven expenditure is likely to generate a more favourable growth-inflation trade-off, since productive investment expands aggregate supply over time rather than only aggregate demand. Third, coordination between fiscal and monetary authorities is essential; independent, inflation-targeting monetary policy can offset some of the inflationary risk associated with deficit spending, but only if fiscal deficits do not become so large or persistent that they compromise central bank independence or force debt monetisation. Fourth, deficit financing strategy should diversify funding sources and lengthen debt maturity profiles to reduce rollover risk and limit the extent to which large deficits crowd out private credit, particularly for small and medium enterprises.

8. Limitations of the Study

Several limitations should be acknowledged when interpreting the results presented in this paper. First, the empirical analysis relies on simple descriptive statistics and bivariate correlation rather than a multivariate econometric model; as such, it cannot control for confounding variables such as global commodity prices, monetary policy stance, exchange rate movements, or external demand conditions, all of which independently influence both inflation and growth. Second, the twelve-year sample period, while capturing a useful range of fiscal conditions including a major exogenous shock, is relatively short for robust time-series inference and includes structural breaks, most notably the COVID-19 pandemic, that can distort correlation estimates and should ideally be modelled explicitly using dummy variables or structural-break techniques. Third, the analysis focuses on a single country; while India offers a useful illustrative case given its combination of substantial fiscal deficit variation and relatively transparent data reporting, the generalisability of the specific correlation magnitudes to other economies, particularly those with different monetary regimes or capital account arrangements, is limited. Future work extending this analysis to a cross-country panel with fixed effects, or applying vector autoregression and Granger causality tests to a longer national time series, would help address these limitations and provide firmer causal evidence.

9. Conclusion

This paper examined the relationship between fiscal deficit, inflation, and economic growth through a combination of theoretical review and descriptive empirical analysis. The evidence indicates that fiscal deficit is positively, though moderately, associated with inflation, and that its relationship with GDP growth is shaped substantially by the business cycle and by exogenous shocks rather than by deficit spending alone. These findings caution against simplistic policy narratives that treat fiscal deficits as either uniformly harmful or uniformly beneficial. Instead, the growth and inflation consequences of fiscal deficit hinge on its financing method, its expenditure composition, the credibility of accompanying monetary policy, and the state of the economy at the time the deficit is incurred. Future research employing longer time-series, cross-country panel data, and formal econometric techniques such as vector autoregression or structural break analysis would help disentangle causal direction and further refine the policy guidance offered here.

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