

# Research paper on budget deficit and its impact in the economy

[Economics](#), [Budget](#)



# **Budget Deficit and its Impact in the Economy**

## **Introduction**

Every government has a budget of its sources of income and expenses. Yearly, the budget is reviewed and a new one is rolled out. The government may either have a budgetary surplus or deficit. A budget deficit occurs where the expenditure of the government exceeds the revenue that it has collected in a certain period. There have been arguments by different scholars on the adverse and positive effects of budgetary deficits on the country's economy. I will highlight the positive and negative effects of the budget deficit and the different causes of the deficits. The adverse effects outweigh the positive effects and a country should endeavour to avoid consistent budget deficits year after year.

## **The Effects of Budget Deficits.**

A high budget deficit impacts negatively on a country's economy. In order to stabilise the budget, the government may choose to apply monetary or fiscal measures. The government will have to seek funds from the public or abroad. There are several ways that the government can finance the budget. The government may borrow funds from abroad, sell government bonds, sell government assets or engage in monetisation. It may issue out government bonds in order to get public financing. However, this tends to reduce the amount of money that the private sector would have used for investments. To attract buyers, the government has to issue the bonds at very high interest rates. These bonds and bills are sold by the Central Bank. They are mostly purchased by the financial institutions. The personal investors usually

buy the premium bonds and national savings certificates. The government by issuing bonds at higher interest rates also

increases the size of the government debt. It will have to pay the private investor's debt at a higher rate. The future generations of the country will have a higher debt service. In servicing debts, the country suffers as it incurs an opportunity cost. The amount of money that would have been used in investing in productive sectors of the economy is used to service debts. This is an opportunity cost for the economy. Additionally the high payment of debt has been highlighted by economists as causing undesirable redistribution of wealth from the tax payers to the private and personal investors. It increases the gap between the poor and rich in the economy.

When a government decides to borrow funds from abroad, it causes an increase in the amount of foreign debt. There is a loss of the foreign currency reserves when the time comes for the country to pay back the debt.

Borrowing from abroad also causes an increase in the real exchange rate.

Monetisation is a method where the government decides to print money in order to cover its expenses. It is highly discouraged by economists as it leads to hyperinflation (Metin, 1998). The budget deficits impact different countries differently. Countries with fully developed financial markets and huge private savings experience less adverse effects of budget deficits than developing countries with lesser amounts of private savings. It is a cycle since persistent budget deficits lead to loss of consumer confidence. These people end up not too willing to buy bonds, leading to the government increasing the level of interest rates even higher. The government may decide to increase taxes in

order to finance the budget deficit.

This will serve to discourage people from working hard to earn more money or investing in businesses to get higher profits. Governments also spend quite a lot of resources in defence in increasing the security of the country. Economists have highlighted that defence expenditure plays a big role in plummeting inflation. This is because most governments prefer to cut expenditure in non-defence expenses and increasing taxation in order to finance defence expenses.

Defence spending is criticised as it is not productive like other forms of government spending in areas such as transport and education. The industries or companies that are contracted by the government to provide military goods are few. They focus on making profits by increasing the prices of the goods. They do not pay particular attention in reducing costs. It has also been argued that an increase in defence machinery demand causes the supplier companies to demand more labour, capital and machinery.

The productive and critical areas of production in the economy will therefore face shortages in the supply of these factors of production. These other areas of production will therefore set higher prices for their goods leading to sectoral inflation due to the high prices.

Defence expenditure abroad also increases inflation. This component of expenditure affects the balance of payments. Consequently there is a payment deficit leading to the downward revaluation of the foreign currency rate (Starr et al, 1984). This causes the imports to be very expensive while the exports face favourable prices. This leads to increase in exports and decrease in imports further increasing the rate of inflation.

The private investors are discouraged from getting involved in importing machinery for investment due to the loss of value in the local currency. However there have been arguments by some economists on the benefits of high government borrowing and spending. Some scholars argue that the high government expenditure will lead to economic growth. This is because the government is spending a lot in the investment of national capital assets and infrastructure like transport. In the long run this expenditure will benefit the economy greatly.

The transport infrastructure will expand the supply capacity of the businesses in the production of goods and services. An investment by the government in education and health is argued to be beneficial since it is an investment in the labour productivity and employment. Businesses in the long run will not face a scarcity in recruitment of educated, skilled and healthy individuals. The investments in welfare helps reduce the costs the government would have incurred in the criminal justice system as the people are provided with their basic needs. It reduces the incentives or reasons for the disadvantaged youth in the society to engage in crime.

### **There is also the perceived benefit of budget deficits as a tool for government to increase spending in the economy.**

The Keynesian theory supports government deficit spending as it leads to economic growth. There are times when there is a very low level of consumption or spending in the economy. When the government chooses to spend more money, the supply of money in the economy increases.

Consumers engage in consumption of goods and services. Businesses are motivated to invest in production of goods and services (Eisner, 2008).

Banks have more money to loan to customers. They give customers loans at lower rate of interests. The Keynesian economists believe that deficit expenditure is actually desirable and necessary for the growth of the economy in the long run.

## **Causes of Budget Deficit**

There are different reasons why a country would have a budget deficit. One of the reasons could be loss of revenue due to lower tax collection. The country has to come up an adequate tax collection system that limit tax evasion. The penalties for tax evasion should be high enough to deter such behaviour. The people should have the knowledge that if they evade tax they will be found out or traced and they will be punished. If this is the main cause of budget deficit, the country should focus on ensuring adequate tax collection instead of resorting to borrowing from abroad or printing more currency (Siddiqi & Ilyas, 2011).

Another factor that contributes to budget deficits is the high level of government spending in areas such as defence, health, education and transport. The government in collecting taxes from the citizens has a role to provide essential goods and service to the public such as education, health and security. The particular levels of expenditure vary from country to country as per the country's policies or laws. When the budget is revealed to the public annually, it is a matter of great interest the amount of money the government has set specifically for these critical areas.

## **Conclusion**

In light of the mentioned effects of budget deficit, the adverse effects are weighty. The country should therefore look for ways to reduce budget deficits to a manageable level so that in the long run, the economy is not stagnant in growth.

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