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Some Aspects of Deficit Finance in Developing Countries

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INTRODUCTION

It has been seen in recent years that the role of government is increasing almost everywhere and the increase in government activities is causing for the increase in government expenditure. Since the government cannot meet all its desired expenditures through its revenue it has to depend on deficit financing, which in most of the cases is done either from borrowing from the central bank or printing more money. In some case, deficit is financed also by borrowing from private sector. In either case, deficit financing affects the economy, however, the nature of the effect may differ, depending upon the technique used to finance the deficit. Considering these issues, this paper attempts to analyze the effect of deficit finance in different macroeconomic variables of the economy.

The study is based on the secondary source of studies and constitutes mostly with the deficit financing issues in developing countries. The analysis is based on both theoretical as well as empirical studies.

PURPOSE AND SOURCES OF DEFICIT FINANCE

Often it is argued that the function of modern government is not only the maintainance of law and order in the country and the protection from external attack, but also to enhance the economic well being of the general people. This is further emphasized by putting the case for equalization of distribution of income and welfare program for the poor segments of the society. Moreover, in most underdeveloped countries, the governments even claim its legitimacy in participating in economic activities for the growth of the economy, which in turn has resulted for a large public sector economies in those countries.

As the government cannot meet all its required expenditures for its above mentioned activities from its existing sources of revenue, it faces budget deficit which are financed through different sources. The different sources of financing the deficit is as follows:

The treasury has five ways of financing the deficit. First, the Treasury can draw down its demand deposits-checking account balances at the commercial banks which directly transfers ownership of part of the money supply to the public increasing the public's net financial assets, but does not change reserves and leaves monetary sector unaffected.

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Second the treasury can sell bonds to the non-bank public which will not affect the reserves and thus leaves monetary sector unaffected. But when the treasury spends the proceeds of bond issue, it restores the public's holding of money which results in an increase in the public's net financial assets by the amount of the bond sale.

Third the treasury can sell bonds to the commercial banks, which will not change the reserves and thus leaves monetary sector unaffected. But this will reduce the lending to the private sector, as the bank has to adjust its assets portfolios for the additional government securities.

In all above cases, since the reserve is unaffected, the monetary sector remains unaffected too. But it will affect the real sector through the increases in government expenditure and the rate of interest. The effect on output and employment depends upon the nature of the economy whether it is in full employment (or near full employment) or not. In the event when the economy is in full employment situation the effect will be only on increase in the price level not in the output level. This happens because of the reduction in the investment demand through the money market (because of the increase in the interest rate). However, if the economy is below its full employment level, the increase in the government deficit finance may increase the output level through the increase in aggregate demand. But since in most of the cases the economy is in full employments level such an action is not expected to create some positive effect on the economy.

The fourth way the treasury can finance the deficits by selling bonds to the central bank in exchange for the deposits. After the treasury spends the funds, the ownership of the deposits will be transferred to the public which ultimately is transferred to the commercial banks as the demand deposits. Here it is obvious that such deposits will then become additional reserves to the banks and the money supply will expand by a multiple of the increase in the reserve. This technique of financing the deficit will reduce the rate of interest which in turn will increase the investment demand and thereby an increase in output. Here again if the potentiality for increasing the output is limited such an expansionary monetary policy can end up only with the increase in the general price level.

The fifth way the treasury can finance the deficit by drawing down its balances at the central bank which also increases money supply through the same channel as just described above.

IMPACT OF DEFICIT FINANCE: SOME THEORETICAL CONSIDERATIONS AND EMPIRICAL FINDINGS

The use of deficit finance is argued on the basis of economic growth and stability of the economy. Many economists believe that deficit finance (often also called inflationary finance) can be used as vehicle of development. Government deficit financing-growth logic is quite straight forward. In the national economy model, it is believed that a change in government expenditure or investment will have its impact on the aggregate output level of the economy through the multiplier effect. Therefore, the

change in government expenditure is considered as a fiscal measure to change the output level. However, the size of the change in the aggregate output level is determined by the multiplier value. Since the increase in the government expenditure through an increase in tax will have both positive (because of the increase in government expenditure) and negative (decrease of consumption due to the increase in tax) multiplier effect, the desired increase in the level of output and employment is not achieved. Because of this, in most of the cases the government prefers to use deficit finance instead of raising taxes. But at the same time the increase in deficit finance also increases the money supply, which in turn pushes the price level upward. Therefore in most of the cases it is claimed that deficit finance induced growth will accompany some degree of inflation.[1]

Deficit Finance and Growth

Those who believe in Keynesian economics they argue that the expenditure of funds raised by taxation, represents mainly substitution of one form of expenditure from another i.e. a reduction in private spending and an increase in government spending. But the expenditure through deficit finance represents new expenditure, therefore an addition to the effective demand. Emphasizing this logic they recommend for the public investment programme from borrowing rather than from taxation. They further argue that, since the government is not a figure entity like an individual and represents the whole economic system, if it spends more money than it takes away from the public in the form of taxes, there must be a net addition to the money income available for spending by the public. And this net addition of money income is a net addition to the effective demand which further creates more employment and increases the real national income. They further argue that out of the increased income saving will increase by an amount equal to the deficit.[2] Following this argument, most of the developing countries use deficit financing as the vehicle of development. They believe the deficit spending if used in appropriate development projects, will have a two fold effect. In the first instance it will increase the aggregate demand which in turn will increase the income level, and second after the development project is completed, it will yield some net benefit in the economy. In the process, however, they also believe that there will be some increase in the general price level, which mostly is found in the acceptable level.

But there are certain group of economists who argue against deficit financing on the ground of welfare cost associated with the inflation. They argue that deficit financing causes for inflation which in turn imposes substantial welfare cost on the holders of the real balances. In this regard Mundell[3] has developed a model in which government receipts are used for production of capital goods, thereby raising the real rate of growth. Assuming a constant capital output ratio, Mundell shows that maximum growth is achieved when the rate of monetary expansion is set to maximize the real government deficit. He further argues that the growth achieved by deficit financing is rather small, while the welfare cost of inflation is quite large.

Agheveli[4] in turn argues that Mundell's argument overlooks the fact that even small increases in the rate of growth of output could be quite significant when the corresponding increase in the level of discounted consumption over a time is considered. To prove it he developed an inflationary finance growth model, in which he derived the optimal rate of monetary expansion for the case when the government resorts to deficit financing to generate additional investment. He further tested his model to draw some empirical implications and concluded that when the costs of inflationary finance (induced welfare costs of inflation) as well as the corresponding benefits (higher level of consumption associated with higher rates of capital formation) are introduced into growth model, explicitly, one can make a case for moderate rates of inflation, which will have little welfare cost.

Although the purpose of Aghevli's article is only to derive the optimal rate of monetary expansion for the case when the government resorts to deficit financing to generate additional investment, it suffers from various qualifications. First it assumes the constant private rate of living which further leads to the conclusion that the inflation tax revenue comes at the expense of private consumption, without affecting private saving. It also assumes no effect of monetary expansion or private saving which is not valid. Further, the whole analysis is based on the assumption that government spending is solely for productive investment which is not valid as the most part of government expenditure often takes the form of nonproductive consumption.

Deficit Finance and Inflation

Generally it is assumed that inflation is always associated with deficit financing of the government. This argument is based on the assumption of inelastic supply function at full employment level. It is argued that when the economy is at the full employment level, an increase in the money supply due to deficit financing will create a gap between output demanded and output supply which is eliminated through the rise in the price level. To counter this logic some people argue that if the government sells bonds to the non-banking public to finance the deficit, the money supply may not increase, therefore there might not be the possibility of rising the price level. But such an action will reduce the private investment and consequently the employment and output level will decrease. This however may become offset by the multiplier effect of the increase of the government expenditure on the output level. But the output level will not increase beyond the original level. Because of this typical crowding out effect, most of the governments choose the sources of financing the deficit, which does not squeeze the money holding the private sector. In any case such financing increases the money supply which in turn pushes the price level upward due to the excess of aggregate demand to the supply.

International Monetary Fund (IMF) has made some interesting studies on the relationship between deficit finance and inflation in various underdeveloped countries. Among them one is the study by Aghevli and Khan.[5] Using a simultaneous equations and simulation method they examined the relationship between the increase in the money supply and inflation

due to the fiscal deficits in four developing countries namely Brazil, Columbia, The Dominican Republic and Thailand. The basic hypothesis of the study was that, while government expenditures rise concomitantly with inflation, government revenues would tend to fall behind the real terms owing to the collection lags. The financing of this inflation induced deficit would then increase the money supply and generate further inflation. Thus the increase in the supply of money due to the budget deficit, would both cause inflation and would be the result thereof. The results of the study of the four countries mentioned above supported their hypothesis confirming the financing of the inflation induced deficit increases the money supply which generates further inflation. On the basis of this findings they have concluded that, in developing countries, fiscal policy tends to be automatically destabilizing, the principal built-in-destabilizer being the various revenue lags. Hence a passive fiscal policy in the times of inflation is hazardous. On the basis of this finding they recommended for elimination of budgetary deficit or even to achieve surpluses, during the time of inflation.

Deficit Finance and Balance of Payments

Most of the developing countries are import oriented. Therefore an increase in money supply due to a budget deficit is likely to increase the import demand (due to the increase in nominal income) which in turn reduces the current account balance of the country. Effect on the balance of payments due to an increase in money supply becomes more stronger in relatively open economy rather than a closed one. But in an open economy, the effect of the increase in the money supply is not felt much on the price level, as it is leaked through import. In this regard, K.E.A. DeSilva[6] studied the impact of monetary expansion due to the budget deficit on the price level and the balance of payments in Sri Lanka using simultaneous equation system with 15 years yearly data from 1959 to 1874. Concerning the money supply price relationship, he found the rate of monetary expansion has exerted a significant influence only after 1967, and the impact of monetary expansion is felt only after a fairly long time. In the study he also found the impact of money supply, due to deficit financing, on the price level was negligible during the period 1959 to 1967, because of the nonexistence of import restriction. However, it affected the increase in the general price level only after 1967, when import restriction was imposed in the country.

SUMMARY AND CONCLUSION

The involvement of government in the economic activities in the name of development and welfare program accompanied by increase in its other activities in recent years has been increasing the government expenditures in many developing countries. Since the tax base of such countries is low, they cannot meet their expenditure through revenue, consequently they face a situation of budget deficit. The budget deficits are mostly met through foreign aid, borrowing (both internal and external) and deficit financing. Since foreign aid is an exogenous factor the government cannot rely on it and moreover it cannot be available up to the desired level. External borrowing depends upon the credit worthiness of a country and obvious the credit worthiness of a poor developing country is very low.

Therefore large borrowing to meet all the government deficit is also not possible. Moreover large borrowing will also increase the debt servicing obligation, which a responsible government mostly would not like to take in absence of its economy's capacity. As far as internal borrowing is concerned, due to low level of income, there is little savings in the economy which, it borrowed by government, will reduce the private investment resulting the decline in the income level. In absence of the possibility and less desirability to finance the required expenditures from the above sources, the government uses deficit financing as the only resort. But deficit financing adversely affects the different sectors of the economy. Theoretically as well as empirically also the growth arguments of deficit financing has not been found valid as the deficit financing is absorbed through increase in the general price level as well as the import. Increase in price in turn results the welfare loss to the society and the balance of payment deficit drains the foreign reserve. Moreover, it has also been found that the inflation induces further budget deficit due to the collection lags of the revenue over expenditure, and it has become both the cause for inflation and result thereof. Therefore, government budget deficit and deficit financing is not desirable in developing countries, as it has little advantage over the large cost to the society. Considering this fact, the government should eliminate the budget deficit by cutting down its activities. The government should follow the notion of "little government the best." This will eliminate the budget deficit and the resulting economic problems from it.

FOOTNOTES

1. Aghevli, Bijan B., "Inflationary Finance and Growth", Journal of Political Economy, 1977, Vol. 85, No. 6.

2. Dillard, Dudley, The Economics of John Maynard Keynes, Prentice Hall, New York, 1948, p. 110.

3. Mundell, R.A., "Growth Stability and Inflationary Finance", Journal of Political Economy, Vol. LXXIII, No. 9, April 1965, pp. 97-109.

4. Op. cit., Footnote No. 1.

5. Aghevli, Bijan B. and Khan, Mohsin S., "Government Deficit and Inflationary Process in Developing Countries", IMF Staff Papers, September 1978, pp. 383-416.

6. Silva, K.E.A. de, "Money Supply Inflation and Balance of Payments in Sri Lanka", The Journal of Development Studies, Vol. 13, No. 2, January 1977, pp. 22-36.