

## IMPACT OF BUDGET DEFICIT FINANCING ON ECONOMIC STABILITY IN NIGERIA

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**ABSTRACT:** *Nigeria has been financing budget deficit overtime but their implications on economic stability have not been fully ascertained. This study sought to investigate the implications of budget deficit financing on economic stability in Nigeria between 1970-2013. The study adopted regression analysis. The study revealed that External Source of Deficit Financing (EXF), Non-banking Public Source of Deficit Financing (NBPF) and Exchange Rate has significant and positive implications on Economic Stability proxy for Gross Domestic Product (GDP), while Ways and Means Source of Deficit Financing (WM), Banking System Source of Deficit Financing (BSF) and Interest Rate (INTR) has negative implications on economic stability in Nigeria. The implication is that government deficit financing through External Source of Deficit Financing (EXF) and Non-Banking Public Source of Deficit Financing (NBPF) will maintain economic stability while government deficit financing through Banking System Source of Deficit Financing (BSF) and Ways and Means Source of Deficit Financing (WM) will reduce economic growth thereby causing instability in the economy. We, therefore, recommend that deficit financing in Nigeria should be focused on the productive sectors of the economy. This is because deficit financing has merely resulted in economic instability indicating that sound policies are needed to achieve economic stability in Nigeria.*

**KEYWORDS:** Budget, Deficit Financing, Economic Stability, Economic Growth, Ways and Means, Banking System.

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### INTRODUCTION

Economic stability is a term that has been in focus for the past several years mainly because of the economic downturn experienced globally in the recent past. Economic stability measures the worth or strength and competitiveness of a country with other countries and it plays a very important role in making policies. Countries formulate economic policy with the aim of stabilizing the economy, among others. The achievement of economic stability is the duty of government in any economic system, irrespective of its political arrangement. Private sector operators are concerned about economic stability because it impacts on their performance. Mordi (2006) states that maintaining relative stability is crucial for both internal and external balance and hence, growth in an economy. Economic stability refers to an economy that experiences constant growth and low inflation.

GBOSI (2002) cited in Ojong and Hycent (2013) defines economic stability as the achievement of price stability, maintaining full employment and achieving sustained economic growth. This means that economic stability is desirable because it encourages economic growth rate that brings prosperity and employment. Shane (2014) opines that economic stability in the economy of a region or country shows no wide fluctuations in key measures of economic performance, such as gross domestic product. This means that stable economies demonstrate modest growth in gross domestic product (GDP) and jobs while



holding inflation to a minimum. Government economic policies strive for stable economic growth rate and prices, while economists rely on multiple measures (national income, consumption, inflation, investment, international trade and international finance) for gauging the amount of stability. Maintaining economic stability is partly a matter of avoiding economic and financial crises, low savings in economic activities, stable inflation and excessive volatility in exchange rates. In other words, economic instability can increase uncertainty, discourage investment, impede economic growth and reduce living standards (Geoff, 2009).

Meanwhile, the value of deficits as a percentage of Gross Domestic Product (GDP) declined to -0.1 percent in 1999. The share of deficits in total GDP has been declining from -2.0 percent in 2003 to -1.1 percent in 2005 and -0.6 percent in 2006. Nigeria recorded budget deficit equal to 1.80 percent of the country's GDP in 2013 (Nigerian Budget Office, 2014). The Nigerian government budget averaged 2.10 percent of the GDP from 2006 up till 2013, reaching an all-high 4.60 percent of GDP in 2008 and also recorded low of -6.6 percent of GDP in 2009 (Nigerian Budget Office, 2014). This is necessary because economic stability is referring to the absence of excessive fluctuations in the macro economy and an economy is considered economically stable when there is constant growth in the economy.

## **REVIEW OF RELATED LITERATURE**

### **Concept and Nature of Deficit Financing**

The issue of deficit financing has been in focus among scholars because whenever there is budget deficit in any country, what comes to the mind of experts in finance is the remedy for financing such budget deficit so as to obliterate the negative effects on the economy. Financing represents government's sources of remedying deficit or utilizing surplus. Deficit financing arises each time the government has budget deficit. However, for the economy to grow as planned in a budget, shortfall of revenue resulting from excess expenditure has to be financed by raising fund from other sources available to the government. Deficit financing can be seen as the practice of seeking to stimulate a nation's economy by increasing government expenditures beyond revenue sources (CBN, 2012). This means that deficit financing can be defined to mean financing undertaken by a corporation or government to make up for a shortfall in revenue. Government or corporation may undertake deficit financing in order to provide an economic stimulus.

When government expenditure tends to exceed public income, the government may resort to deficit financing to meet the deficit in the budget. Keynes theory recognizes the idea of deficit financing as a compensatory spending meant to solve the problem of unemployment and depression. Modern economists prescribe deficit financing for developmental purposes. Nwaotka (2004) defines deficit financing as a planned excess expenditure over income, dictated by government policy or creating fund to finance deficit by borrowing whether from internal or external sources, which must be repaid with interest within a specific period of time. Deficit financing is defined in finance as government spending in excess of revenues which is financed by borrowing. Keynesian economist's theory states that deficit is financed in order to increase economic activity and reduce unemployment in a nation.

Stiglitz (2005) sees deficit financing as a situation in which the federal government's excess fund of outlays over receipt of revenue for a given period is financed by borrowed funds from the public. Deficit financing can also be seen as the sale of debt securities in order to finance



expenditures that are in excess of income. This method of financing can also be seen as non-banking public source of financing. Generally, deficit financing is applied to government finance because income, represented by tax revenues and fees, is often unavailable to pay expenses. As with monetizing the debt, deficit financing puts upward pressure on interest rates because government debt securities compete with private securities for limited capital (Smriti, 2010).

### **Sources of Financing Fiscal Deficit**

Government all over the world always look out for different options to financing its fiscal deficit. The main two sources are:

1. **Borrowings:** Fiscal deficit can be met by borrowings from the internal sources (public, commercial banks, etc.) or the external sources (foreign governments, international organisations, etc.).
2. **Ways and Means:** This implies printing of new currency by the apex bank. Government may borrow from Central Bank of Nigeria (CBN) against its securities to meet the fiscal deficit. Central Bank of Nigeria (CBN) issues new currency for the purpose of financing its fiscal deficit. This involves deficit financing. Borrowings are considered as a better source as they do not increase the money supply which is regarded as the main cause of inflation. On the other hand, the use of Ways and Means may lead to inflationary trends in the economy due to more money supply.

### **Concept and Nature of Economic Stability**

Economic stability refers to an absence of excessive fluctuations in the macro economy. An economy with fairly constant output growth and low and stable inflation would be considered economically stable. Economic stability is a term that has been in focus for the past several years mainly because of the economic downturn experienced globally in the recent past. Many share markets plunged and business plummeted, giving rise to one of the worst economic crises experienced by the present generation. Many lost their jobs and some saw their savings evaporate at a rapid pace. Thus, this brings out the important question, how important the economic stability is, as having an unstable economy can pave way to an economic crisis each time the global markets see a downward trend (Pandula, 2012).

### **Economic Stability Variables or Measures**

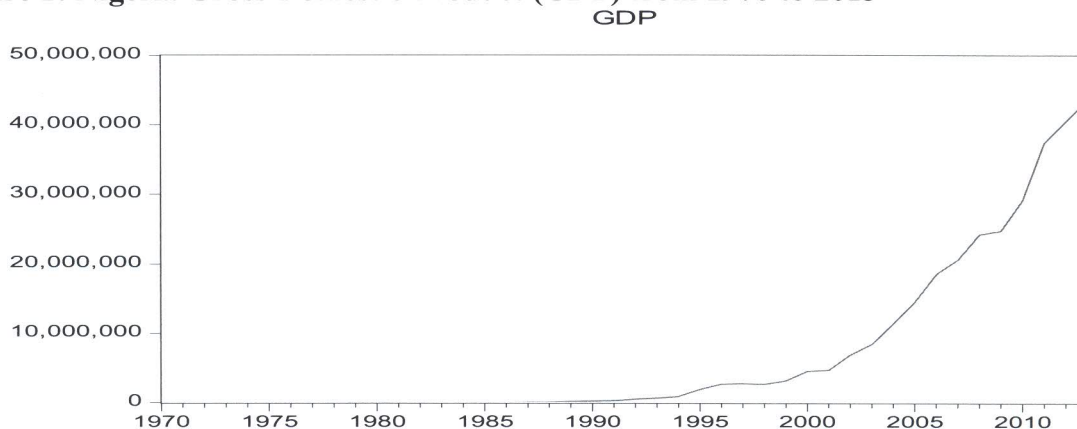
In any economic system like ours, there is always the need for undertaking very useful measures aimed at determining the stability of the economy. Due to the nature of this research work, economic stability is proxy as gross domestic product (GDP), inflation rate and unemployment rate in Nigeria. This is because economic stability refers to an economy that experiences constant output growth, low or stable inflation rate and maintaining full employment by maintaining low unemployment. However, no one variable can measure the stability of the economy. The variables or measures are explained below:

### **Gross Domestic Product (RGDP)**

In this work, gross domestic product (RGDP) will be proxied as one of the exogenous variables to measure economic stability. This is because economic stability measures the sustainability of economic growth of a country. It refers as to the market or money value of all goods and services produced in a country at a particular period of time. Gross Domestic Product (GDP) measures the economic size of a country. It also measures how fast the nation

economy is growing. It is an important indicator or measure of economic stability. Abu and Achegbulu (2012) notes that gross domestic product (GDP) variation in Nigeria is used to measure the level of economic stability in the country. Hassan and Okorafor (2013) opines that gross domestic product is one of the measures of economic stability in Nigeria because economic stability refers to an economy that witness constant growth in the economy. Therefore, to calculate the GDP, one only needs to add together the various components of the economy that are a measure of all the goods and services produced.

**Figure 1: Nigeria Gross Domestic Product (GDP) from 1970 to 2013**



Source: Author's Computation 2014

Looking at the figure 1 above, it shows the trend of economic growth in Nigeria for 44 years starting from 1970 to 2013. In the overall period, the economic growth trend maintained upward growth and a little fluctuation during the period under review. It shows how inefficient budget deficit financing affect economic stability and it was used based on the existing literature and theories.

### Theoretical Framework

There are many theories (Keynesian economics theory, neoclassical economics theory, Ricardian equivalence approach, Fiscal Theory of Price Level and Musgrave Theory of Public Expenditure) which seek to explain the implications of deficit financing on the performance of economic stability around the world. These theories are of relevance to this study as they serve as building blocks to this thesis. For the purpose of this study, the theoretical frameworks that were considered relevant are as follow:

#### Keynesian Economic Theory

Keynesian Economic Theory was developed by British Economist John Maynard Keynes (1936) and was used by Ali (2014); Bakare, Adesanya and Bolarinwa, (2014); Muhammad, Sofia, Syed and Abbas, (2014); Okelo, Momanyi, Lucas and Alia, (2013); Okoro, (2013); Ojong and Hycenth (2013) in their studies. Keynesian theory states that public expenditures can contribute positively to economic growth by increasing government consumption through increase in employment, profitability and investment. The theory also states that government can reverse economic downturns by borrowing money from the private sector and returning the money to private sector through various spending. This theory believes that active government intervention in the market place through deficit financing was the only method for ensuring growth and stability by ensuring efficiency in resources allocation, regulation of markets, stabilization of the economy and harmonization of social conflicts. Keynes states



that in the short run, economic growth through economic stability is strongly influenced by total spending in the economy. This theory regards the economy as being inherently unstable and required active government intervention through spending to achieve economic stability. Parkim (1990) opines that Keynesian assign a low degree of importance to monetary policy and high degree of importance to fiscal policy. Bowden (1982) in Ojong and Hycenth (2013) states that Keynesian economics believes that our ability to understand what determines the level of spending will help us to know what determine the level of employment, production of output and income in the economy. Keho (2010) states that budget deficit has a positive effect on macroeconomic activity and thereby stimulating savings and capital formation. Deficit financing whether through domestic resources or foreign borrowings involves the absorption of real resources by the public sector that otherwise would be available to the private sector (Okelo, Momanyi, Lucas and Alia, 2013). Keynesian theory stimulates the economy, reduces unemployment and makes households feel wealthier using government spending (Usher, 1998). In another view, Okpanachi and Abimiku (2007) opine that budget deficit stimulates economic activities in the short run by making households feel wealthier and hence, raising total private and public consumption expenditure. This means that Keynesian theory causes money demand to rise and interest rate will also increase which will make investment to decline. Keynesian economists often argue that private sector decisions sometimes lead to inefficient macroeconomic outcomes which require active policy responses by the public sector, in particular, monetary policy actions by the Central Bank of Nigeria and fiscal policy actions by the federal Ministry of Finance, in order to stabilize output over the economy.

### **Empirical Review**

Iyoha (2000) investigated the impact of external debt on economic growth in sub-Saharan African countries using simulation approach. It was observed that external debt variables has significant impact on economic growth in sub-Saharan African countries and that debt stock reduction would have significantly increased investment and growth performance. The study concludes that mounting external debt depresses investment through both a disincentive effect and a crowding out effect.

Adam and Bevan (2001) investigated the relationship between fiscal deficit and growth for 45 developing countries using co-integration model and threshold. It was found that there is significant relationship between fiscal deficit and growth in developing countries and that there is evidence of interaction effect between debt stocks exacerbating the adverse consequence of high deficit.

Brauninger (2002) examined the interaction of budget deficit, public debt and endogenous growth in Spain using co-integration analysis. It was revealed that if the ratio of deficit fixed by government is below a critical level, then there are two steady states where capital and public debt grow at the same constant rate and an increase in the deficit ratio will reduce the growth rates of gross domestic product (GDP). This means that if the deficit ratio exceeds the critical level, then there is no steady state of economy.

Pattillo, Helene and Luca (2002) used growth accounting model to investigate the effect of external debt on economic growth in a group of 61 developing countries. The study observed that doubling the average level of 61 developing countries external debt reduced the growth of the country's economy. The results obtained confirm the debt overhang because they found



that beyond the debt-to-export ratio of 160-170 percent and debt-to-GDP ratio of 35-40 percent in nominal value, the debt overhang led to negative economic growth.

Clements, Rina, Benedict and Toan (2003) used modified growth model to investigate the impact of debt burden hypothesis on economic growth. The study found that a six-point debt service reduction in percentage of GDP will increase the investment rate from 0.75 to one point and the growth to two points. They concluded that if half of the debt service were cancelled without a rise in the budget deficit, growth will increase by 0.5 percent per annum.

With the use of non-parametric methodology in an economy, Adeboye (2003) examined the long run relationship between budget deficit and economic growth incorporating savings and investment. He grouped 64 developing countries, Nigeria inclusive into A, B, and C based on their level of interest rate. The study indicates that crowding out effect of budget deficit on private investment in Nigeria's economy has significance impact on the economic growth output, the level of employment, the standard of living. The study recommends that the government should put adequate measures in place to reduce its recurrent expenditure and increase its capital expenditure in order to encourage and make conducive environment for private investment to grow which will help the level of income growth in short and long run.

Okoye and Akenbor (2010) examined the impact of deficit financing on socio-economic activities in Nigeria from 1997 to 2007 using Pearson product moment correlation coefficient to test the significance of the relationship between deficit financing, economic and social community service. The study found that deficit financing has a positive and significant impact on economic activities in Nigeria.

Taiwo and Agbatogun (2011) used unit root test, co-integration test and error correction model to investigate the implications of government spending on economic growth in Nigeria spanning from 1980 to 2009. It was found that total capital expenditure, inflation rate, degree of openness and current government revenue are the most significant variables that help to improve or boost growth in Nigerian economy. It was recommended that future spending on capital and recurrent must be managed well with adequate manipulation of other macroeconomic variables so as to ensure steady growth in the economy.

Vincent, Ioraver and Wilson (2012) investigated the relationship between fiscal deficit and economic growth in Nigeria using modeling technique that incorporates co-integration and structural analysis at 5% (0.05) level of significance from 1970 to 2006. The study with the help of co-integration techniques indicates that fiscal deficit affects economic growth negatively, that there is one percent increase in fiscal deficit which is capable of diminishing economic growth by about 0.023 percent and there is a strong negative relationship between government consumption expenditure and economic growth.

Onyeiwu (2012) investigated the relationship between domestic debt and the growth of Nigeria economy. Parsimonious model, error correction model and ordinary least square (OLS) were used for analysis. He employed gross domestic product as dependent variable while foreign exchange rate, credit to private sector, budget deficit, money supply domestic debt. It was found that the domestic debt holding of government is far above a healthy threshold of 35 percent of bank deposits the average over the period. This means that the level of bank deposit is presenting evidence of crowding out private investments. The study also indicates that the level of domestic debt in Nigeria has negative effect on economic

