

## Deficit Financing in Contemporary Economies: Effects and Implications

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**ABSTRACT.** Ann Pettifor's paper on deficit financing elucidates how Keynesian policies in times of economic slumps reduce public deficits. A public misconception is that during economic downturns, increasing government expenditure will worsen the deficit. Deficit financing aims to increase economic output via creating/salvaging jobs and increasing productivity. Thus, the temporary increase in spending creates a long-term increase in economic output, so the size of the deficit in relation to GDP ultimately decreases. However, effective targeting of government expenditure is critical if it is to benefit the economy. Evidence from the United States, Taiwan, and Bangladesh, shows how deficit financing used effectively, and not solely to gain political capital, is necessary to produce economic growth.

**Keywords:** Deficit, GDP, Government Spending, Financial Crisis and Tax Cuts.

**JEL Classification:** E12, E50, E52, E62, F65, H62

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## 1. Introduction

A government to spur economic growth in the country usually carries out deficit financing, but whether or not it actually influences growth has been hotly debated. Despite the vast discussion of this provoking topic in the economics literature, no conclusive outcome has been reached. In many Least Developed Countries (LDCs), government budget shortfalls covered by deficit financing has played a vital role in building capital. Budget deficits may happen for many reasons, but it typically signifies an attempt to accelerate the economy by lowering taxes or increasing government spending.

Different schools of thought exist in the literature on how to relate the fiscal deficit to economic growth. In Keynesian economics, government expenditure is one important component of Aggregate Demand (AD) in the economy. When AD falls short (during recessions), the government can increase expenditure, which in turn will increase AD, and in turn, will stimulate the economy. This solution based on government stimulus packages worked well to increase output, employment, and income to bring the U.S. economy out of the Great Depression of 1929-1933 and out of the most recent Great Recession of 2007-2009. The same practice was followed by several other countries over the years to stimulate AD and the pace of economic growth (Hussain & Haque, 2017).

Developing countries often have low savings and investment compared to more developed countries. Thus, these countries often do not have enough resources to invest in major developmental projects. Deficit financing plays an important role to fill the difference. Nevertheless, deficit financing may also happen from government inefficiency due to tax evasion or wasteful spending. When forming fiscal policy, it is thus essential to keep in mind the causes for deficit financing.

Islamic financing is one of the rapidly growing segments in the financial sector of the world today and is thus an important topic of study. Many Western big banks, including Citigroup, HSBC, and Deutsche Bank, as well as financial capitals like London, Tokyo, and Hong Kong, are all going into the Islamic banking business. Many studies address the relationship between Islamic finance and economic growth and the role of Islamic banks in

mobilizing savings to stimulate economic growth (Benes & Kumhof, 2012; Wolf, 2014). Boukhatem and Moussa (2018), attempt in their study to empirically test the impact that Islamic banking loans had on the economic growth of 13 countries in the MENA region during the 2000-2014 period. The authors found strong evidence to suggest that the financial system development stimulated economic growth in the selected MENA countries over the studied period. Moreover, net-oil-exporting MENA countries do not appear to benefit from large oil-fueled deposits that are likely to increase the scale of loans. They suggest that governments should consider implementing proactive and favorable economic and institutional policies that align with Islamic finance.

The remainder of this paper is structured as follows. Section 2 reviews the lead paper of Ann Pettifor (2019) and discusses some of the topics mentioned in the paper with reference to the U.S. economy. Section 3 presents a view of economic development with historical evidence from Taiwan, a once very poor nation that quickly became one of the wealthiest countries in the world, and current evidence from Bangladesh, a Muslim-majority LDC. Finally, section 4 concludes the paper.

## 2. Discussion on the Lead Paper

Ann Pettifor's (2019) paper on deficit financing elucidates how Keynesian policies in times of economic slumps reduce public deficits. A common misconception is that during economic downturns, since output decreases, increasing government expenditure will worsen the deficit. However, these arguments ignore the effects deficit financing has on the economy. Deficit financing aims to increase economic output via creating/salvaging jobs and increasing productivity. Thus, the temporary increase in spending creates a long-term increase in economic output, so the size of the deficit in relation to GDP ultimately decreases.

The mechanism that drives the increase in GDP from Keynesian policies is the multiplier effect, in which the increased output from government expenditure is more than the government expenditure itself. For instance, the cost of improving highways and roads is less than the gains in a nation's GDP

stemming from more jobs, less costly trade, etc. Several advocates of austerity measures argue that the multiplier effects are small and exaggerated, and point to evidence such as “roads to nowhere” regarding infrastructure investments. These arguments do, however, have some kernel of truth to them; roads built in locations where they will not be heavily used will generally not increase output as much as roads built connecting densely populated areas. Effective targeting of government expenditure is crucial for a nation to get the most “bang for its buck”. Recent advances in the field of spatial economics have made it possible to identify which locations benefit the most from certain government expenditures. For instance, Allen and Arkolakis (2016), use commodity flow data to show which parts of the U.S. would benefit the most from improvements to the interstate highway system.

Although deficit financing is crucial in times of economic slumps, it is important to keep in mind the political slant that deficit financing entails, as deficit financing is often used by policymakers to generate political capital. In 2002, then Vice President Dick Cheney said, “Reagan proved *deficits don’t matter*” (Leung, 2004, para 29). President Reagan took office in January of 1983 and the national debt of the U.S. as on 9/30/1982 stood at \$1142 billion and the debt/GDP ratio at that time was around 34%. On 9/30/1990, the national debt stood at \$3233 billion and the debt-to-GDP ratio rose to 54%. Reagan, a Republican president, gave tax cuts to spur growth. For the Republican Party, the statement “deficits do not matter” only applies when they are the party in power, but when the power changes hands from the Republican to the Democratic Party, the tune changes. Republicans then hurl loud clarion calls, claiming that entitlements and other social benefits need to be trimmed to cope with the rising debt. The chart below (table 1) shows the ratio of debt-to-GDP in the United States from 1982 to 2021 (projected) (see, Amadeo, 2018). In a New York Times op-ed dated October 18, 2018, Paul Krugman, a Nobel Laureate in Economics, wrote

when the Trump tax cut was on the verge of being enacted, I called it “the biggest tax scam in history”, and made a prediction: deficits would soar, and when they did, Republicans would once again pretend to care about debt and demand cuts in Medicare, Medicaid and Social Security.

Sure enough, the deficit is soaring. And this week Mitch McConnell, the Senate majority leader, after declaring the surge in red ink “very disturbing”, called for, you guessed it, cuts in “Medicare, Social Security and Medicaid”. He also suggested that Republicans might repeal the Affordable Care Act – taking away health care from tens of millions – if they do well in the midterm elections.

Any political analyst who didn’t see this coming should find a different profession. After all, “starve the beast” – cut taxes on the rich, then use the resulting deficits as an excuse to hack away at the safety net – has been G.O.P. strategy for decades. (Krugman, 2018, paras 1-3)

Deficit financing will only increase output if it is used effectively and not used to win political points, as it is often done.

The Republican Party, however, has had a habit of raising the deficit not when the country is in need, but when it is beneficial to their own political interests, rather than the public interest. The conservative (Republican) practice of cutting taxes while spending millions on wars has led to the largest debt in half a century, and to one of the worst recessions of recent time (the 2008 financial crisis). Even before being sworn in as the president of the USA in January of 2009, the then president-elect, Barack Obama, had to work out emergency rescue plans for the economy in November-December of 2008. Obama inherited an economy in January of 2009 that was on the verge of collapse and had to take drastic action. The Federal Reserve, led by Ben Bernanke, slashed the interest rate, and in May of 2011, the interest rate was around 1/8% for 3 month T-bills. The country was not even out of recession, but again, eyebrows were raised by Republicans as to why interest rates were being kept so low, despite the fact that the country was still coping with the financial crisis of 2008.

**Table (1) National Debt by Year Since 1982: Compared to Nominal GDP and Major Events**

<b>End of Fiscal Year</b>	<b>Debt (as of 9/30, in billions)</b>	<b>Debt/GDP Ratio</b>	<b>Major Events by Presidential Term</b>
1982	\$1,142	34%	Reagan budgets from 1 <sup>st</sup> term. Recession.
1983	\$1,377	37%	
1984	\$1,572	38%	
1985	\$1,823	42%	
1986	\$2,125	46%	Reagan lowered taxes. S&L Crisis.
1987	\$2,340	48%	
1988	\$2,602	49%	
1989	\$2,857	50%	
1990	\$3,233	54%	Bush 41 budgets. Desert Storm. Recession. Debt growth slowed.
1991	\$3,665	59%	
1992	\$4,065	62%	
1993	\$4,411	64%	
1994	\$4,693	64%	Clinton budgets. Budget Act reduced deficit spending.
1995	\$4,974	65%	
1996	\$5,225	64%	
1997	\$5,413	62%	
1998	\$5,526	61%	Last Clinton budgets. 9/11 attacks. Recession. Bush added \$22.9 billion to FY01 budget for War on Terror.
1999	\$5,656	58%	
2000	\$5,674	55%	
2001	\$5,807	55%	
2002	\$6,228	57%	First George W. Bush budgets. War on Terror cost \$409.2 billion. Bank bailout cost \$350 billion. Bush tax cuts.
2003	\$6,783	59%	
2004	\$7,379	60%	
2005	\$7,933	60%	
2006	\$8,507	61%	War cost \$752.2 billion. Katrina cost \$24.7 billion. ARRA added \$241.9 billion to FY09 budget.
2007	\$9,008	62%	
2008	\$10,025	68%	
2009	\$11,910 (\$11,000 on Mar 16 and \$12,000 on Nov 16)	83%	
2010	\$13,562 (\$13,000 on Jun 1 and \$14,000 on Dec 31)	90%	Obama Stimulus Act cost \$400 billion. Payroll tax holiday ended. War cost \$512.6 billion. Great Recession and tax cuts reduced revenue.
2011	\$14,790 (\$15,000 on Nov 15)	95%	
2012	\$16,066 (\$16,000 on Aug 31)	99%	
2013	\$16,738 (\$17,000 on Oct 17)	99%	
2014	\$17,824 (\$18,000 on Dec 15)	101%	War cost \$309 billion. QE ended. Strong dollar hurt exports.
2015	\$18,151	99%	
2016	\$19,573 (\$19,000 on Jan 29)	104%	
2017	\$20,245 (\$20,000 on Sep 8)	103%	
2018	\$21,66 (\$21,000 on Mar 15)	104%	Congress raised debt ceiling.
2019	\$22,703 (est.)	108%	Trump tax cuts and spending above sequestration. Congress suspended the debt ceiling until 2019.
2020	\$23,901 (est.)	108%	
2021	\$25,020 (est.)	108%	

Source: (Amadeo, 2018).

Paul Krugman wrote on May 11, 2011 in the New York Times Magazine that:

The global financial crisis of 2008-9 had its roots in more than two decades of growing complacency in wealthy nations, a complacency whose main financial manifestation was ever-growing leverage. Bankers and households alike piled on levels of debt that would have been sustainable only if nothing ever went wrong. Inevitably, something did – and a result was to force much of the advanced world into a harsh process of deleveraging, of slashing spending to pay down debts. ... Well, as I see it, the biggest danger for the United States isn't that there's another financial crisis lurking out there, ready to pounce. It is instead that we'll get confused by all the crisscrossing signals in the global economy and end up focusing on the problems we don't have while ignoring the problems we do. Not to put too fine a point on it: I'm worried that Ben Bernanke may end up being bullied into raising interest rates when he should do no such thing. There will eventually come a day when the Federal Reserve Board should tighten – but that day is years away. (Krugman, 2011, para 5 & 13)

As Ann Pettifor (2019) writes “given these flaws, it is no wonder that the economics profession as represented by the London School of Economics could not answer the British Queen’s question: Why was the crisis not foreseen? Why did no one notice it?” (p. 67). This was a question raised by the British Queen in November of 2008 *after the* worldwide financial crisis had erupted and has been cited many times as embodying the public’s consternation. The financial crisis of 2008 happened under the watchful eyes of President G.W. Bush (or Bush II), a Republican president and his vice president, Dick Cheney, whose quote of 2002 “deficits don’t matter,” gave us the entire dreadful outcome. Paul Krugman addresses the concern raised by the British Monarch with the query “how did economists get it so wrong”? In a New York Times article dated September 02, 2009, he writes,

few economists saw our current crisis coming, but this predictive failure was the least of the field’s problems. More important was the profession’s blindness to the very possibility of catastrophic failures in a market economy. ... As I see it, the economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth. ... [He

concludes] When it comes to the all-too-human problem of recessions and depressions, economists need to abandon the neat but wrong solution of assuming that everyone is rational and markets work perfectly. The vision that emerges as the profession rethinks its foundations may not be all that clear; it certainly won’t be neat; but we can hope that it will have the virtue of being at least partly right. (Krugman, 2009, paras 3, 6 & last para)

Taking into account the possibility of market failure is crucial for designing policy and the belief that deficit financing is unnecessary as “markets will fix themselves” is also naïve, as evidence shows that markets can break down.

### **3. Economic Development**

In the context of developing countries, large government expenditure programs aimed at increasing output and decreasing poverty are known as “big push” strategies. The poverty trap literature has argued that without a big push, underdeveloped countries will find them stuck at a low GDP state and will be unable to move up. To many, this strategy of spending when lacking the means may seem foolish, but historical evidence shows that it pays off. Taiwan, for example, is considered one of the major “growth miracles” of the 20<sup>th</sup> century (al-Fathi, 2012). Although many people argue that it was the high savings rate that caused this rapid economic growth, they are neglecting the fact that before Taiwan began saving a lot, the government made significant financial investments to restructure their agricultural sector, build schools, and construct roads. These investments paid off, by increasing agricultural output so that residents of Taiwan no longer had to spend the majority of their incomes on food, by allowing more residents to obtain formal education, and by facilitating migration/commuting to urban areas where incomes are higher. Thus, since Taiwanese residents had more disposable income, they were able to naturally save more. This increase in savings lowered the interest rate, thereby spurring on more private investment. Taiwan’s initial expenditures in the 1950s, when it was a poor, underdeveloped country, allowed Taiwan to grow rapidly. All initial expenditures had large multiplier effects, which allowed Taiwan’s GDP per capita to become one of the highest in the world.

Bangladesh, the world's third largest Muslim-majority country, provides recent evidence on the importance of deficit financing for economic growth. Although the United Nations classifies Bangladesh as the largest least developed country (LDC) in terms of population and economic size, it is likely that Bangladesh will leave the LDC category by 2024, propelled by better health and education, and an economic boom (Gay, 2017). According to the World Bank's report, "Bangladesh has an impressive track record for growth and development, aspiring to be a middle-income country by its 50<sup>th</sup> birthday [2021]" (The World Bank, 2018b). GDP for the country was \$249.724 billion in 2017. In the past decade, the economy has grown at nearly 6 percent per year (The World Bank, 2013; The World Bank, 2018a). The Bangladeshi government has unveiled a record Tk 4,64,573 crore (about 55.31 billion U.S. dollars) national budget for the 2018-2019 fiscal year starting in July 2018. The budget deficit is expected to be around 5% of GDP. About 11.7% of the budget-financing source will be from foreign loans and grants ("Muhith unveils Tk 4,64,573cr budget for FY19", 2018).

Hussain and Haque (2017) research the relationship between fiscal deficit and its impact on economic growth in Bangladesh. The authors highlight that the quality of government expenditure is important and that government expenditure should be undertaken after careful planning. It should be effectively implemented so that benefits of such projects are substantial. The government should give priority to projects that deal with public goods and generate positive externalities. The private sector alone will not provide enough of such goods, some of which are essential to national development. Nevertheless, the government must keep the deficit under control so that the growth of the economy may continue without any pause. Fiscal policy has an important role on the growth of the economy in Bangladesh. Therefore, it is imperative on the government's part to carefully formulate the tax policy (to generate revenue) and expenditure policy (checking wasteful expenditure and curbing corruption), keeping in mind that such policies have a significant impact on growth. Fiscal policy adjustment that reduces unproductive expenditure and protects expenditure in the social

sector can lead to additional sustainable level and is likely to result in faster growth. The level of government expenditure should be set so as to avoid huge deficits leading to debt financing and the crowding-out effect of private investment. If deficits become unsustainable, it can lead to higher interest payments, loss of confidence, and lower GDP growth rate. Given the low level of savings and investable funds, as is typical in a developing country like Bangladesh, the need to mobilize more resources (both foreign and domestic) to invest in productive sectors of the economy can hardly be overemphasized. The authors end by saying that, in the economics literature, there is no definitive conclusion as to whether fiscal deficits help or hinder economic growth for a country, and many argue that a fiscal deficit leads to economic growth, which cannot be achieved only through domestic savings, as the current level of domestic savings may not be enough for investment. *It can be accepted safely that a certain level of fiscal deficit is good for economic growth, if the borrowed money is spent for beneficial projects, and the return from such investments exceeds the funding cost.*

#### 4. Conclusion

Increasing spending when times are bad may seem counterintuitive. However, as Pettifor (2019) emphasizes, common wisdom regarding spending for private households is not applicable when discussing government expenditure. A government's purpose is to serve its citizens, especially in times of need, and thus it is the responsibility of a government to finance job creation schemes and other programs to increase output when the economy is in a slump. Nevertheless, this review of Pettifor's article emphasizes the need to target deficit financing appropriately, in both developed and developing countries. Deficit financing should not be used to win political points or enable corruption, but should be targeted to provide for the segments and aspects of society, which are most in need of and will make the most out of an economic boost. By effectively targeting its expenditures to make the most of the multiplier effect, the size of the economic "cake", as Pettifor puts it, will grow and thus the budget deficit's share of the "cake" will ultimately decrease.

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## تمويل العجز في الاقتصادات المعاصرة: الآثار والنتائج

### محفوظ الحق

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المستخلص. توضح ورقة آن بتيغور حول تمويل العجز كيف أن السياسات الكينزية في أوقات الركود الاقتصادي تقلل من العجز العام. هناك اعتقاد عام خاطئ أن زيادة الإنفاق الحكومي خلال فترات الانكماش الاقتصادي ستؤدي إلى تفاقم العجز. يهدف تمويل العجز إلى زيادة الإنتاج الاقتصادي من خلال خلق/إنقاذ الوظائف وزيادة الإنتاجية. وهذه الطريقة فإن الزيادة المؤقتة في الإنفاق تخلق زيادة طويلة الأجل في الناتج الاقتصادي، وبالتالي فإن حجم العجز في الناتج المحلي الإجمالي ينخفض في نهاية المطاف. ولكن لكي تؤدي هذه النفقات الحكومية وظيفتها وتكون مفيدة للاقتصاد، فإن الاستهداف الفعال لهذه النفقات أمر بالغ الأهمية. تظهر الأدلة من الولايات المتحدة وتايوان وبنغلادش كيف أن تمويل العجز المستخدم بشكل فعال، وليس فقط للحصول على نفوذ ورأس مال سياسي، ضروري لتحقيق النمو الاقتصادي.

**الكلمات الدالة:** العجز، الناتج المحلي الإجمالي، الإنفاق الحكومي، الأزمة المالية وتخفيض الضرائب.

**تصنيف JEL:** E12, E50, E52, E62, F65, H62

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