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Budget Deficit Financing and Its Economic Impacts: A Case Study of Iraq for the Period (2004-2023)

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Abstract: The government budget can either be in deficit or surplus. A deficit occurs when the government spends more than its revenue, while a surplus happens when government revenues exceed its expenditures. As a result, a deficit in the government budget adds net financial assets to the private sector because a budget deficit means the government has deposited more money and bonds into private assets, whereas a surplus means the opposite. The government has three options to meet its expenditures. The first option is that the government can generate revenue by imposing taxes. The second option is that the government may direct its expenditures by borrowing, issuing government debt instruments such as treasury bills and government bonds. The third option is that the government can issue currency and use it to pay for goods and services it wishes to purchase.

Keywords: Financial Deficit, Public Expenditures, Public Revenues.

1. Introduction

The financial deficit refers to the difference between public expenditures and public revenues, meaning that expenditures exceed revenues. This concept has become a chronic economic phenomenon that most countries, both developed and developing, continue to suffer from. Different measures have been used to quantify this deficit, each with certain foundations used to clarify the concept of the deficit [1], [2].

The conflict between economic schools of thought has continued, as new ideas emerged advocating for the reduction of the state's role and cutting public expenditures, which led to continuous budget deficits, increasing government borrowing, and higher taxes on income and wealth. This weakened the incentive for private investment [3]. These ideas also called for reducing social subsidies, which had encouraged the phenomenon of unemployment, contributing to increased stagflation. The issue of domestic financing has become one of the most prominent challenges facing developing countries, forcing them to seek external financing, which is often conditioned on complex political and economic terms [4], [5], [6].

The budget deficit is a phenomenon that can be observed, and while it is found in the economies of developing countries, it also appears in the economies of some developed countries, where the deficit ratio has exceeded the acceptable threshold in relation to the Gross Domestic Product (GDP). This ratio has evolved over time, and if the budget deficit leads to growth in GDP, and at a higher rate than the growth of the deficit, it means that the increase in public expenditures has contributed to economic development [7], [8]. Thus, the phenomenon of the budget deficit can become an acceptable one that stimulates the economy.

Research Importance

Citation: o'g'li S. H. M. Trends In Implementing Green Standards In The Sustainable Service Sector. American Journal of Economics and Business Management 2025, 8(7), 3643-3650

Received: 08th Apr 2025

Revised: 15th May 2025

Accepted: 28th June 2025

Published: 27th July 2025



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The importance of the research lies in the fact that fiscal policy in Iraq has a significant impact on economic activity [9]. When a fiscal deficit occurs, its effects spill over into macroeconomic variables due to its interconnectedness with other economic policies [10]. This creates a shock to economic activity, resulting in either expansionary or contractionary effects on macroeconomic variables, the intensity of which varies depending on the magnitude of the deficit and the possibility of addressing it.

Research Problem

The research focuses on the issue that Iraq's fiscal policy during the period (2004-2023) suffered from an imbalance in its tools, characterized by fluctuating public revenues – sometimes increasing and sometimes decreasing. This led to the occurrence of a deficit, despite the disparity between the planned budget and the actual budget [11], [12].

Research Hypothesis

The research is based on the hypothesis that the deficit requires different sources of financing, which may either be domestic or external. These sources have economic effects on macroeconomic variables such as money supply, Gross Domestic Product (GDP), interest rates, and the balance of payments [13], [14].

Research objective

The research aims to define the various concepts of the deficit and its sources of financing. Additionally, it seeks to clarify the impact of financing the government budget deficit on economic variables.

2. Materials and Methods

The researcher relied on descriptive and inductive analysis to determine the size financial deficit in the economy, assess its economic effects, and identify the mechanisms for addressing the deficit.

First: The conceptual framework of budget deficit, its causes, and effects the budget deficit is considered one of the traditional economic phenomena, similar to other problems and phenomena such as inflation and unemployment. It is a phenomenon experienced by most countries around the world. This issue reflects, in simple terms, the increase in public spending beyond public revenues, and at the same time, it reflects the contains the executive authority's estimates of the state's expenditures and revenues for a future time period, usually one year, and is approved by the legislative authority, it reflects the political, economic, and social objectives of the state.

A. Metrics used to show and measure the budget deficit:

1. The first measure is the overall deficit: This measure shows the deficit by subtracting expenditures from revenues, so it is the negative difference between the total of the two. According to this measure, total public expenditures include interest payments and do not include payments for amortization of government debt, while public (government) revenues include tax and non-tax government revenues, but do not include income from borrowing, so the deficit here represents or reflects the gap that is covered by government borrowing, including borrowing from the central bank.
2. The second measure is public debt: It is defined as the difference between the total current expenditure, net ownership of physical capital assets and net ownership of financial assets on the one hand and tax and non-tax revenues on the other hand, and the deficit in this case measures the net government borrowing adjusted by changes in money holdings, which are small, so the budget is balanced and the net borrowing is equal to zero.
3. The third measure is the current deficit: It measures the difference between current expenditures and current revenues, and neglects capital expenditures and capital revenues such as selling assets. The logic behind this is that increasing government spending on government revenues in the area of investments does not change the status of government assets, because new debt is offset by new government assets.
4. The fourth measure is the operating deficit: The deficit here represents the borrowing requirements of the government and the public sector minus the part of the interest paid to correct inflation through a monetary correction factor, as the interest rate paid to creditors

includes part of the money to compensate them for the losses they incur as a result of rising prices, and the deficit is measured in inflationary conditions.

5. **Structural Deficit** This measure attempts to remove temporary or exceptional obstacles to the state's general budget, such as deviations in domestic income, interest rates from their long-term values, and price changes. It excludes sales of government assets, as these represent non-recurring revenue.
6. **Hidden Deficit** These results from quasi-financial operations, such as subsidies on interest rates and exchange rate guarantees.
7. **Domestic Deficit** This is calculated by subtracting external grants and government expenditures from government revenues. It reflects the government's financial position excluding external grants.
8. **Eighth Measure: Neutral Budget**

This measure is used by the International Monetary Fund (IMF), and it involves comparing public expenditures with the Gross National Product (GNP) in a base year when the economy is at full employment. Based on this comparison, the neutrality of public spending in a specific year is assessed.

B. Causes or justifications of the budget deficit:

It is obvious that fiscal deficits occur when public expenditures exceed public revenues, but how did this situation become normalized? What are the reasons that led to this?

1. Causes of the budget deficit and its aggravation:

In the following, we address the reasons for the increase in public spending in a way that made expenditures exceed revenues and how the state's public revenues failed to keep pace with this increase in expenditures.

2. Reasons and justifications for the increase in public expenditures:

- a. **Apparent reasons:** It is the one in which the arithmetic figure of public expenditure increases without being accompanied by an increase in the real value of the quantity of goods and services used to satisfy the public needs of the country's territory as an area or population.
 - b. **Real Causes:** It is the actual increase in the real value of public spending in relation to the territory of the state as an area or population at a certain time or the increase in the per capita share of the services performed by the state.
- ##### 3. The reasons for the apparent increase can be determined as follows:
- a. **Currency depreciation:** As wars pushed countries to resort to financing them by issuing excessive paper currencies that exceeded their cover, monetary inflation occurred and the value of the currency deteriorated, and this led to paying more monetary units to obtain the same amount of goods and services
 - b. **Different accounting methods:** The transition from the net budget to the gross budget method, which is the recording of all expenditures and revenues, leads to inflating the public expenditure figure in the budget without being matched by a real increase in the services provided, and the nationalization of some projects (water, electricity and transportation) increases the figure without being accompanied by the emergence of new services.
 - c. **Expansion of the territory:** The increase in public expenditures may be due to the increase in the population or the area of the territory, so the government's spending figures increase, but the increase in area or population leads to an increase in state revenues, so the government's expansion in its spending does not lead to an increase in public costs. In order to recognize the real increase in such cases, assuming constant purchasing power and fiscal art, we have to calculate the average per capita public expenditure.

The apparent increase may be due to the fact that the period being estimated is longer than the usual period (a year), which usually happens when the start of the fiscal year is adjusted

3. Results and Discussion

1. As for the reasons for the real increase in spending, we can identify them as follows:
 - a. Economic reasons: It is represented by the increasing government intervention in economic activity in developed and underdeveloped countries, as the government aims to achieve economic stability and balance after the failure of the market mechanism to achieve this in developed countries, and to push the development process in developing countries because it is difficult for the private sector to carry out this task
 - b. Social reasons: Public spending has come to include spending on education, public culture, public health, and social insurance to achieve a minimum standard of living for some social groups, as well as the construction of housing by public bodies in some countries [15], [16].

The borrowing process is no longer an exceptional means of financing public spending, as it was in classical thought, as the state resorted to it in cases of natural disasters and wars, but the government resorted to it to finance public spending, and the use of bonds increased due to the ease of borrowing

- c. Cash deficit and fiscal deficit in the budget:

After mentioning the details of public expenditures and public revenues separately, the idea of benefiting from this occurs only when the two sides are compared in one document, namely the general budget, where through this interview and comparison between public expenditures and public revenues, the financial position of the state is determined, whether surplus or deficit, and if the estimated public revenues are sufficient to cover the estimated public expenditures, the budget is described as identical and balanced, and if there is a real increase in estimated public expenditures over estimated public revenues, the budget is in a state of deficit [17], [18].
2. It is important to recognize that budget deficits are of two types, monetary and fiscal, as follows
 - a. Cash deficit: The cash deficit appears in the identical and balanced general budget, in which the expected public revenues are sufficient to cover the expected public expenditures, when there is a delay in the collection of regular revenues on the dates specified in advance due to the seasonality of collecting some public revenues, and at the same time spending remains current, which causes a deficit in the cash liquidity of the public treasury, which is called the cash deficit, and the treatment of this deficit is by the state issuing short-term treasury bills (91 days), as they have high liquidity and do not risk defaulting on their maturity for their short terms.
 - b. Fiscal deficit: The fiscal deficit is defined as a real increase in public expenditures compared to public revenues during one fiscal year, and the state addresses this deficit by issuing public treasury bonds that are characterized by a medium to long-term duration, and the reason for the state's resort to this loan (public treasury bonds) is its inability to cover the fiscal deficit during the fiscal year.
3. Measures that would achieve fiscal balance or reduce the deficit in the general budget:

These institutional measures are usually associated with the measures applied by many countries with the aim of achieving fiscal discipline by relying on a number of Fiscal Policy Rules, limiting the exercise of some Quasi-Fiscal activities by central banks, and avoiding the central Quasi-Fiscal Deficit, which appears as a result of the losses that the bank may realize, where the concept of Quasi-Fiscal Deficit is of great importance in the context of coordination between fiscal and monetary policies.

With regard to fiscal policy rules, the deterioration of fiscal policy performance in many industrialized and developing economies alike - during the 1970s and 1980s - raised interest in following these rules, as the importance of fiscal rules comes to support weak

institutional performance, and to establish the principles of credibility and fiscal responsibility in developing countries and major industrialized countries.

These rules refer to the constraints that are used to regulate the government's use of various financial instruments. These constraints are expressed in the form of indicators, and these indicators are divided into three groups: Deficit Rules aim to reduce the budget deficit to a certain level and then turn this deficit into a surplus, Borrowing Rules aim to achieve rationality in the choice of public financing methods, and Debt Rules aim to determine a safe limit for the total public debt, and the main objective of fiscal rules is to regulate the general budget deficit and ensure the achievement of the state's long-term fiscal sustainability or ensure the government's ability to fulfill its financial obligations, which leads to achieving public financial discipline, and these rules may be defined at the local level or at the regional level in international agreements.

Second, Sources of financing the budget deficit:

The state resorts to multiple sources to finance its financial deficit. These sources may be local through its banking system or from outside this system and may be external financing by resorting to countries, organizations, banks and private companies, according to the needs of the state available for financing and its political, economic and social orientations, the selection of appropriate sources of financing is the first step towards mitigating the negative effects of the deficit and the beginning of the road towards addressing these effects.

1. The concept of finance

Financing through banks and financial institutions has become the catalyst for economic activity by providing the necessary funds to establish new projects and expand existing projects in order to increase production, and with the end of the nineteenth century and the beginning of the last century, banks in developed countries played an important role in the financing process, and each country in this regard followed a different policy from other countries according to its circumstances, and financing is terminologically the set of actions and behaviors that provide us with the means of payment Financing also means providing funds for a new investment, and if the investor does not have these funds from his savings, he borrows it from another saver, and some economists define it as the supply of capital or a cash loan for the need to implement projects .Others define it as all executive actions that result in obtaining money and investing it in various operations that help maximize the value of the money expected to be obtained in the future in light of the money currently available for investment, the expected return, the risks surrounding it, and the trends of the financial market.

2. Source of financing

Economic studies and literature have addressed the division of financing sources from various perspectives, some studies have classified them into internal (self) financing and external financing.

Internal financing is represented by ownership funds and uses tools such as common stocks, preferred stocks, and retained earnings. On the other hand, external sources (i.e., from outside the project) include loans in their various forms—short-term, medium-term, and long-term loans—bonds, as well as trade credit and lease financing. Some studies have classified financing into direct and indirect financing. Direct financing involves dealing with all primary financial instruments issued by borrowing companies and marketed directly without the intervention of financial intermediaries. It uses stocks and bonds for long-term financing or commercial paper for short-term financing. On the other hand, indirect financing occurs through financial intermediaries due to the difficulties faced by both savers and borrowers in direct financing. The most commonly used tools in this type of financing are loans in all their classifications.

Third, financing cost:

Investment decisions in projects are closely related to the method of financing and its cost, Projects that wish to obtain funds from the funding source must be able to

achieve a return that is at least equal to the returns available from other alternative investment opportunities available to investors that have the same risk rate, so achieving a return below this rate (the cost of funds) leads to the financial condition of the project. In other words, the cost of funds represents the minimum rate to be achieved on investment projects to maintain the market value of the company's shares without change, so achieving a return below this rate (cost of funds) leads to the financial condition of the project becoming poor with a decrease in the market value of the company's shares, while achieving a return above this rate leads to an improvement in the financial condition of the project with an increase in the total market value of the company's shares, and in order to calculate the average cost of funds provided to the project from various sources of financing, the cost of funds must be measured for each source.

Fourth, Mechanisms for reforming the public budget in Iraq.

The public finance situation in Iraq is characterized by the strength of the Iraqi economy, which is characterized by highly volatile oil revenues and successive and significant increases in public spending, especially military spending, so it was imperative for the Iraqi authorities to introduce more reforms that will help the government achieve its public finance goals in the coming period. Moreover, recent expansions in public finance spending may involve the risk of imposing excessive obligations on future budgets with high spending levels that may be unsustainable if oil prices experience a sustained negative shock which is what happened [15].

The preparation of Iraq's budget follows both top-down and bottom-up approaches. A committee is formed, consisting of the Ministry of Oil, the Ministry of Planning, and the Ministry of Finance, to construct the budget through a consultative process. The annual budget prepared by the Ministry of Finance follows a top-down approach, where economic assumptions, public finance policies, and the upper limits of expenditures are determined by economic committees (top-down approach). Meanwhile, the executive ministries submit their expenditure plans to the Ministry of Finance, and negotiations between the Ministry of Finance and the ministries ensure that the expenditures outlined in the budget remain within the total spending limits, reflecting a bottom-up process.

The revenue and expenditure estimates in the pre-2014 budget was characterized by caution, with revenue performance exceeding the amounts allocated in the budget. This was largely due to conservative assumptions regarding oil prices and revenues (the significant and rapid rise in oil prices). In contrast, in the years 2014 and 2015, the budget estimates faced discrepancies. As for public expenditure estimates, the planned expenditure was consistently higher than actual expenditure in the years following 2003, due to the limited absorptive capacity for investment spending, which led to most investment expenditures being rolled over to the following year. It is noted that during the period (2004-2013), the actual budget achieved a surplus, while in the period (2014-2015), a deficit occurred due to the ISIS terrorist group and the substantial increase in military spending. The budget then returned to surplus in the years (2017-2018) due to the rise in oil prices and increased export quantities. However, in the years (2019-2020), the budget experienced a deficit due to a decline in resources, rising debt costs, the war, and current expenditures. The budget returned to surplus in the years (2021-2022), but the surplus decreased in 2023. This indicates that the published (planned) budget provided only limited guidance regarding the potential state of public finances. The government aims to reduce fluctuations in fiscal policy, increase savings for stability and equity purposes, and can consider two possible areas for reform: (1) establishing a medium-term framework for public finances, and (2) adopting rules for public finances, see Table 1.

Table 1. Analysis of the Actual Expenditure and Actual Revenue Structure for the Period (2004-2003)

Deficit or Surplus	Actual Expenditures (Millions of Dinars) 2	Actual Revenues (Millions of Dinars) 1	year
865248	32117491	32982739	2004
14127715	26375175	40502890	2005
10248866	38806679	49055545	2006
15568219	39031232	54599451	2007
20848807	59403375	80252182	2008
2642328	52567025	55209353	2009
44022	70134201	70178223	2010
25231423	78757666	103989089	2011
14677648	105139576	119817224	2012
6894368	106873027	113767395	2013
-6805502	112192125	105386623	2014
-3,927,262	70,397,515	66,470,253	2015
-20,216,646	75,055,865	54,839,219	2016
1,932,058	75490115	77,422,173	2017
25,696,645	80,873,189	106,569,834	2018
-4,156,528	111,723,523	107,566,995	2019
-12,882,754	6,569,312	63,199,689	2020
6,231,805	102,849,659	109,081,464	2021
44,737,855	116,959,582	161,697,437	2022
-6,754,370	142,435,636	135,681,266	2023

4. Conclusion

1. It is expected that the financial dominance of oil revenues will continue in the coming years due to the inability of investment spending to stimulate non-oil sectors, due to the low and fluctuating implementation of investment expenditures.
2. The Iraqi economy's inability to develop other sources of financing and its complete reliance on oil revenues as the sole source of funding for economic activity is evident, especially due to the failure to invest the surplus achieved in the general budget during the period of high oil prices. This became clear through the budget deficit caused by the drop in oil prices, leading to the re-emergence of the problem with a rising deficit on one hand and increasing public debt on the other.
3. The budget deficit is due to large increases in public spending, the low internal elasticity of revenues, and the financing of the deficit, particularly through currency issuance, which leads to a significant increase in the money supply and subsequently raises the inflation rate.
4. The general budget of the Iraqi economy faced two types of imbalances when comparing actual expenditures with actual revenues: the first type was a deficit, and the second was a surplus. Both types resulted from wars, fluctuations in oil prices, and the structural imbalances the Iraqi economy has faced. Therefore, it can be concluded that the imbalance in the general budget was both cyclical and structural.

5. Recommendations

1. Emphasizing the necessity of the independence of the Central Bank, and coordination between it and the government in setting financing policies so that monetary policy does not become aligned with fiscal policy in a way that makes the said bank a soft tool in the hands of the government, as happened in Iraq.
2. Paying attention to increasing investment spending as a percentage of total public spending, especially productive projects to achieve non-oil revenues.
3. Paying attention to developing an advanced tax system in quantity and quality and in proportion to the capacity of the economy by fighting tax evasion and paying attention to direct taxes, and raising their percentage compared to indirect taxes.
4. Iraqi budget planners must control cash flows by amortizing the internal public debt represented by treasury transfers, and separating the direct link between the expansion of the money supply and the expansion of internal public debt.

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