ABSTRACT

Economic growth is an increase of a country's output of goods and services commonly financed by internal and external sources some of which comprise public borrowings. The trend in both domestic and external borrowing by Kenyan government has been increasing while economic growth has shown fluctuating trend. External debt rose from 2.04 billion in 1970 to 1.14 trillion in 2014 while domestic debt rose from 1.16 billion in 1970 to 1.08 trillion in 2014. Annual growth rate was 5.9% in the period 1978-1979 and dropped to 3.1% in the period 1979-2001 and later increased to 4.4% in the period 2002-2014.Following lack of consensus from empirical perspective, relationship between budget deficit financing and economic growth is not clear. Subsequently, despite the role of internal budget deficit financing and external budget deficit financing to the government financing mechanisms, there are conflicting information about their effect on economic growth. The purpose of this study was to determine the effect of budget deficit financing mechanisms on economic growth in Kenya. Specific objectives of this study included: to determine the effect of domestic budget deficit financing on economic growth in Kenya, to determine the effect of external budget deficit financing on economic growth in Kenya and to analyze the effect of external-internal budget deficit financing ratio on economic growth in Kenya. The study used secondary time series data for the period 1970-2014 from Economic Survey published by Kenya National Bureau Statistics. The study was guided by neoclassical growth theory and adopted correlational research design. The models were estimated using Ordinary Least Squares method. The results indicated a positive and significant effect of internal budget deficit financing on economic growth(where$\beta = 0.8302; p = 0.03$).There was a negative and significant effect of external budget deficit financing on economic growth(where$\beta = -0.9385; p = 0.02.$) while the effect of external-internal budget deficit financing ratio on economic growth was negative and significant (where$\beta = -0.8595; p = 0.02.$).The study recommends that policies that will promote consecutive borrowing in order to reduce the negative effect of external budget deficit financing on the economy should be adopted. The government should also find ways of enhancing its revenue generation capacity especially by broadening the tax base to reduce the deficit which is financed by internal borrowing.