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**Article**

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## Increase of Public Debt and Budget Deficit and their Sustainability

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### Abstract

Taking into account the need to ensure a standard of living adequate for citizens, by providing jobs, infrastructure, housing, etc., governments seek to allocate resources for that purpose, most often exceeding the ability to collect revenues to state budget and thus leading to accumulation of budget deficits and, implicitly, to increased public debt. Economic growth is the most important instrument for achieving the social and economic objectives of a central government. All these elements aforementioned intertwine with the external economic environment, the evolution thereof, while negative effects such as the economic crises have a contagious effect on the economy and society in general. After the economic and financial crisis of 2007, the public debts of the states increased, and the sustainability of the public finances has become a matter of major concern.

**Keywords:** public debt, budget deficit, economic growth, debt crisis, European Union, sustainability.

### 1. Introduction

The first economist who addressed the issue of financing government spending through loans or by raising taxes and levies was David Ricardo, who in his fundamental paper "Principles of Political Economy and Taxation" advocated for debt neutrality, because taxpayers should be aware that loans accumulated in time by the government shall lead to tax increases in the future (Kishtainy, 2012). This theory, whereby budget deficits were considered hazards since they led to economic ruin, was seriously challenged by the Great Crisis of 1929-1933, at which point John Maynard Keynes argued that overcoming economic crisis can only be achieved through state intervention in the economy, and this intervention entails making loans and an increased budget deficits in order to stimulate public spending, which will create thereafter jobs creation and implicitly will support economic welfare. Nowadays there are still supporters of the theory of debt neutrality, such as economists Robert Barro, Robert Lucas and Thomas Sargent who belong to the new school of classical macroeconomics, as well as supporters of Keynesian theory, such as Hyman Minsky and Paul Krugman.

As we have shown above, the central topic of the supporters of the neoliberal macroeconomics school is fiscal prudence according to which governments should not spend more than they collect, since spending more than the budgetary revenues generate inflation and undermine economic stability, which affects economic growth and decrease the standard of living of those with fixed incomes. The supporters of the neo-Keynesian economics argue that the public budgets must be balanced, but not on annually basis, but following an economic cycle, since it is necessary to make some extra-budgetary expenses during the economic downturn and to generate budget surplus during the upward trend in a country. It is normal for a developing country to make medium-term extra-budgetary spending on a steady basis as long as the debt is sustainable (H.J Chang, 2012).

### 2. Definitions

The term public debt generally refers to the debt of a country made as a result of contracting loans by central and local governments from legal and natural persons residents in the territory of that country or abroad and which are to be repaid at a certain time. Thus, the public debt can be external or internal, and its structure differs depending on development level of a country. Thus, in the economically developed countries the internal debt has a larger share in the public debt, while in the less developed countries the external debt has a higher percentage in the public debt.

There is no single definition of public debt for which there several approaches, both in the narrow and the broader sense. According to the National Bank of Romania (NBR) and the ESA 2010, Government debt is defined as the total consolidated gross debt in nominal terms at end of period for the following categories of government liabilities (defined in ESA2010): currency and deposits, securities other than shares excluding financial derivatives, and loans.

The public debt is correlated with a country's budget deficit. States are looking to contract loans, in particular, to finance the government's budget deficits. According to the NBR, the government deficit/ surplus is the net financing requirement for the running of the public administration.

The debt of a country is formed by the sum of the debts generated by the central and local governments of a state, and by the public and private companies that operate in a national economy. Public debt is a necessary tool for governments to finance public spending, especially during periods when there is no possibility to increase taxes or to reduce public spending. Increasing a country's public debt can lead to economic instability and even generate economic downturn. A high level of public debt in GDP is perceived as an economic problem by investors and policy makers, because it can negatively influence the capital market and can trigger decreased investments, reduced employment and negative economic growth (Coccia, 2018).

The public financial imbalance is underpinned by the budget imbalance. The public financial imbalance occurs as a result of the increased demand for financial resources in relation to the revenues obtained by the state from taxes and levies. Increasing or decreasing public debt is directly related to the evolution of budget deficits. If the public expenses are higher than the public revenues, there are created prerequisites for the need to make loans in order to cover such expenses and thus contributing to the increase of the public debt.

### **3. An overview of debt in the economies of European countries**

Most of the economies of the European countries are characterized by high public debt and a significant fiscal deficit. States with high public debt are facing many problems when contracting international loans, as was the case in Greece in 2012, if they do not accept repayment plans established by creditors, in order to maintain access to the international market and sustainable interest rates with regard the sovereign debt. The credibility of governments with regard to the management of public debt depends not only on the reputation of the debtors, but also on the financial institutions that would be able to prevent the occurrence of defaults.

Romania, as a member of the European Union, has pledged itself to respecting the budgetary discipline imposed by the Maastricht Treaty, namely not to exceed a budget deficit larger than 3% of GDP and public debt larger than 60% of GDP. These levels are based on concepts defined in the methodology of the European System of National and Regional Accounts (ESA) 2010 edition.

Due to the occurrence of the debt crisis in the countries of Europe, the ability to repay and rescheduling the debts of certain European economies has become a matter of major concern for the European Union (EU), with question marks regarding the economic integration thereof. Following the outbreak of the 2007 financial and economic crisis, International Monetary Fund (IMF) imposed on developing countries, including Romania, budgetary balancing conditions

or even the requirement to register a surplus, regardless of the stage in which the country is within an economic cycle or the development strategy of that country.

In the first years after the global economic crisis, many countries and financial institutions in Europe emphasized the implementation of austerity programs to cut the large budget deficits they faced. The effect of these measures on the evolution of public debt in the national economies of Europe remains uncertain and difficult to assess.

Reinhart and Rogoff (2010) have shown that public debt calculated as a share of GDP can have a detrimental effect on the real GDP growth rate. Thus, if the public debt to GDP ratio is more than 90%, this may slow down economic growth.

This slowdown occurs because financial resources of future generations shall be used to pay interest on current public debts. Moreover, the very existence of a high debt also implies a reduction of the margins of manoeuvre with regard the decrease of taxes and levies. It is considered that a reduction of taxes and levies will lead to the improvement of the economic situation in the long term, but, in the short run, it will result in the deterioration of the public debt.

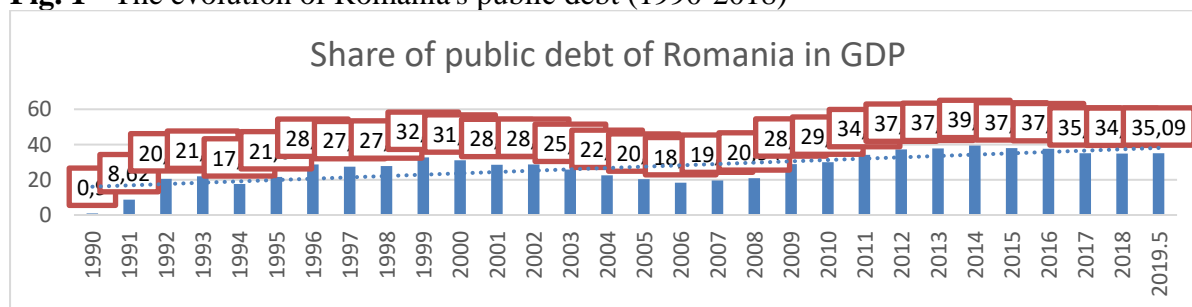
Subsequently, the study carried out by Reinhart and Rogoff proved to be wrong, which affected the economy of the countries which were imposed harsh austerity programs by the IMF. Thus, Olivier Blanchard, chief economist of the IMF, pointed out that the Fund misjudged the impact of austerity on European economies, considering that the researchers underestimated the increase in unemployment and the decrease in domestic demand associated with fiscal consolidation (Blanchard, 2013).

The consequences of the austerity budgets, for which budgetary expenditures were drastically reduced, consisted of the reduction in GDP per capita in 2012 compared to 2007 by 26% in Greece, 12% in Ireland, and 7% in Spain. Thus, it was found that reducing government spending in a stagnant or shrinking economy does not trigger its recovery (H.J Chang, 2014).

#### 4. Sustainability of Romania's public debt

Romania has recently expressed its intention to join the euro area. However, it is a country where the budget deficit and public debt have increased. For 2019, there are forecasts for a budget deficit of up to 3% of GDP and a public debt of around 40% of GDP. Recently, the new liberal government has expressed its intention to increase this deficit up to 3.5% or even 4.4%. Romania has a significant deviation from the medium-term budgetary objective of 1% of GDP provided by the EU "Stability Pact". Thus, the EU Council recommends that the Romanian authorities take the necessary measures to ensure that the increase rate of net primary government expenditure falls within the established limits, but it is noted that no measures have been taken in this respect. Thus, the EU Commission draws attention to the risks and vulnerabilities the Romanian economy faces, such as the unsustainable increase of the level of public debt burden (instalment payments + interest rates) in the coming years, with obvious foreseeable negative effects on the standard of living of Romanian people.

**Fig. 1** - The evolution of Romania's public debt (1990-2018)



Source: <https://datoria.ro/>

The sustainability of public debt is calculated by the dynamics of government debt in GDP and not by the dynamics of the amount in absolute terms. Romania has the fifth lowest share of government debt in GDP among EU28 Members States, i.e. 34.2% of GDP, according to the latest data published by Eurostat in the second quarter of 2019 - well below the alert threshold calculated at 45% of GDP; it has also benefits from a reduced pressure of short-term debt service and a diversified investor base. Long-term foreign debt was approximately € 73,831 million in September 2019, while the short-term external debt was € 34,407 million. According to NBR data, in 2019 the degree of short-term external debt coverage with foreign exchange reserves was 77% compared to 74.3% at 31.12.2018, which indicates a lower probability of facing liquidity crisis. From this point of view, the concerns of the EU Commission do not seem to be well founded, but such concerns concern the stagnation of the structural reforms and the fiscal-budgetary consolidation, given that year-to-year Romania's economic growth is mainly due to stimulating the consumption led growth and not due to production-led growth drivers.

Before the onset of financial and economic crisis of 2007, Romania's public debt has been relatively small, around 20% of GDP, but it doubled by 2014. The main cause was the increase of the budget deficit, caused by the bankruptcy of many companies, the increase of unemployment rate and disintermediation in the banking system overwhelmed by accumulation of defaults.

The factors underpinning the sustainability of the public debt are as follows: the ability of a country's economy to generate primary surpluses, the size of interest on state loans, the risk premium attached, and its own economic growth rate (Socol, 2013). Thus, for the level of public debt in the coming years to be sustainable it is necessary to reduce the primary deficits and/or to generate primary surpluses. One possible solution would be that the interest rates on loans made by the Romanian state do not exceed the rate of economic growth of our country.

## **5. Social and environmental limits of economic growth**

In recent decades, both from a macroeconomics and a microeconomics perspective, the level of debt has increased. This was not due to the shortages, but to the surplus and excess. The society did not suffer from hunger, but faced another dilemma: how to offer a meal to someone who ate too much (Sedlacek, 2012).

The global financial and economic crisis of 2007 shows how much dependence there is on economic growth and how difficult it is to accept the decline of GDP, an indicator introduced and measured consistently, for the first time in 1790 in the U.S.A.

The lack of constraints on government decision-makers regarding spending, taxation or borrowing leads to a significant increase in public debt, and the new generations of taxpayers are facing insurmountable tax burdens.

Those countries where there is an increase in terms of employed economically active population benefit from greater room to manoeuvre in terms of tax cuts, leading to a reduction in long-term pressure on public budget. Even if lowering taxes has a short-term beneficial effect on the government budgetary situation, if this tax reduction takes place amid a reduction in terms of employment of the active population, it can lead to a deterioration of the long-term budgetary situation of that country.

Since public debt is measured as a percentage of GDP, a reduction of debt in order to avoid economic turmoil can be achieved by supporting GDP growth through investment and GDP expansion policies, rather than by reducing public debt through additional taxation measures. The way in which interest rates are set by central banks can influence public debt both in terms of current financing conditions and in terms of government expectations. Thus, central banks have a key-role in determining the government to pursue public debt stabilization policies.

It should be stressed that the GDP level is not a landmark for quality of life and no landmark for economic sustainability. There are extremely important elements, which escape the scope of GDP, such as the assessment of health status, education level, housing conditions of the people, quality of the environment, which are subjective, but also very important elements in human society. GDP is an indicator specific to the present time. It does not take into account what remains to future generations, especially in terms of quality of the environment. Sustainability is a milestone of ongoing developments. We may state that an economy is sustainable if the future generations will have at least the same capital (resources) we have at our disposal today. Therefore, it is about the aggregation of several types of capital (resources): economic capital (corporate, household and public sector' assets), human capital (educational expenses) and natural capital (environment) (Diemer, 2015).

Under the aegis of the European Commission, a report was prepared (Stiglitz - Sen - Fitoussi, 2009) in order to find those tools that are able to quantify, at its true scale, the economic performance of a country, and set a set of 12 recommendations were made, of which we mention the one that underlines that the assessment of sustainability requires a set of clearly defined indicators, which will allow the measurement of the quality of life's dimension in addition to a monetary index.

The issue of pace and limits of economic growth was discussed and debated upon on several occasions, starting with Thomas Malthus, and continuing with the Club of Rome, until now when climate change affects large areas of our world. Economic growth has its limits, the density of the Earth's human population has been increasing, and the discovery of new deposits of raw materials is declining. Although economic and technical progress supports the economic growth, it is very unlikely that energy supply failures or natural resources shortcoming will not occur in the future, in order to keep the annual growth rate of gross world product (GWP). In order to prevent the depletion of resources used in production, the pace at which they are consumed must be reduced (Kolodko, 2014).

## **6. Conclusions**

The advanced economies should aim at slowing down their economic growth pace and, while doing so, they should not be constrained by the social and ecological restrictions, as increasing production does not trigger automatically an increased level of social satisfaction. Developing countries need to be aware that implementation of their aim to accelerate production growth is at the expense of environment safety and generate a rapid depletion of natural resources, ultimately leading to a lower quality of life.

According to Prof. Jorgen Randers - the author of a comprehensive global forecast based on an unprecedented calculation of GWP – by multiplying the number of people aged 15 to 65 who are able to work worldwide with the output they generated, the output it will grow year by year, but the rate of economic growth will decrease by 2050 (Randers, 2012).

The current state of play together with the future constraints will trigger a change in the perception of the economic development of the countries, and the companies shall be evaluated not only by their financial statements, but also by the social and environmental impact of their operations. The interventionist role of the state and the importance of resource allocation related policies by governments shall increase, because the market will not be able to cope by itself with the problems that will arise in the process.

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