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DEFICIT FINANCE – A MODERN TREND IN BUDGET POLICY

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Abstract

In this paper it's analyzed the concept of budget deficit and the trend of this situation in budget policy. That's seen through the comparison of the various member countries deficits and public debt figures as per cents from GDP in previously determined period of time. Since the obvious slowdown in the budget deficit numbers, it is also paid attention to the fiscal rules which led to reduction in the deficits and public debts. Especially focus is enlightened on the functionality of the Stability and Growth Pact, the arguments for existence of fiscal rules and the effects of the debt finance on the economy.

Keywords: budget deficit, public debt, fiscal rules, Stability and Growth Pact, "crowding out" effect, twin deficits.

Introduction

Today almost every country strives to achieve economic development through implementation of deficit finance in fiscal policy. This measure will increase the real GDP form one side, but also will increase the price level on the other. Thus, both on short term are doubtful. The point here is to see how the fiscal rules impact the budget deficit and public debt status in all European Union countries. The comparison between member countries supplies vital data for deficit and debt trajectory. Also it gives attention to the Stability and Growth Pact framework. In order to sustain this way of finance the government must continue to indebt herself to respond to the intensive spending or capital investment in various government projects. In this text we can see the factors that cause governments to decide for implementation of deficit policy.

Historical review of budget deficit and public debt

The budget deficit in the last 20 years had a very substantial progression line in the developing countries, shown as a percentage of GDP. The major deficits appeared after the oil crises in the middle of the 70-ties and dramatically spread out after the 80-ties mainly as a result of the excess public consumption, and not because the inefficiency in the tax payment. The public expenses rose from 28 % from GDP in 1960 to 50 % from GDP in 1994. These deficits were the reason for the intensive accumulation of public debt which increased to 70 % from GDP in 1995 from previous 40% in 1980 and therefore reducing the finances and the exploitation of the economic recourses. The picture was different before the war. The developed countries had fiscal deficits and surpluses that have been low, but the decreasing financial condition of there national treasuries enforced them to borrow against the future. It is very interesting that in the after war period, five from seven big countries still pursued deficit budget policies despite the satisfactory level of economic development. Therefore, many economists consider that the focus on the social programs, demographic trends and fundamental macroeconomic turnovers were the main reasons for the fiscal collapse of many countries or in other words, the negative impact of the major recessions in that countries.

The major problem with this policy is that governments intend to neutralize negative shocks in the economy with budget deficit and therefore not be aware of the problems that could acquire in sense of sustainability of these deficits. The budget deficit inevitably leads to increase in the public debt which must be serviced in the future. So, if the rate of the economic growth is smaller then the interest rate of the government debt, there will be intensified debt affinities leading to never ending increase of the debt-GDP ratio. In that case the only way out for the intensive country indebting will be the creation of money in form of revenues which will reduce the deficit, but in other hand increase the inflation rate.

The budget deficit is defined as difference between what the government spends and what the government collects. The excess of revenues over spending during a period of time is known as budget surplus. There are two sources for government to collect money for realizing it`s fiscal goals, tax and debt. The first one is very unpopular and unpopulistic government instrument for securing money flow, while the borrowing is more acceptable way for collecting additional funds. However to choose between taxes and debt is one of the most sensitive questions in the field of public finance. There are a lot of debates concerning the necessity of the governments to force that kind of fiscal policy, because of potential damages that the economy may suffer in the long run.

In the following table are presented data for the latest deficits and public debt numbers in the European Union through which can be foreseen the dynamic in their movement.

Table 1 Budget deficit and Public debt in EU-27

% from GDP

EU-27	2004		2005		2006		2007	
	Deficit[1]	Public debt[2]	Deficit	Public debt	Deficit	Public debt	Deficit	Public debt
Belgium	0.0	94.2	-2.3	92.1	0.3	88.2	-0.2	84.9
Bulgaria	1.4	37.9	1.8	29.2	3.0	22.7	3.4	18.2
Czech Republic	-3.0	30.4	-3.6	29.7	-2.7	29.4	-1.6	28.7
Denmark	1.9	43.8	5.0	36.4	4.8	30.4	4.4	26.0
Germany	-3.8	65.6	-3.4	67.8	-1.6	67.6	0.0	65.0
Estonia	1.6	5.1	1.8	4.5	3.4	4.2	2.8	3.4
Ireland	1.4	29.5	1.6	27.4	3.0	25.1	0.3	25.4
Greece	-7.4	98.6	-5.1	98.0	-2.6	95.3	-2.8	94.5
Spain	-0.3	46.2	1.0	43.0	1.8	39.7	2.2	36.2
France	-3.6	64.9	-2.9	66.4	-2.4	63.6	-2.7	64.2
Italy	-3.5	103.8	-4.2	105.8	-3.4	106.5	-1.9	104.0
Cyprus	-4.1	70.2	-2.4	69.1	-1.2	64.8	3.3	59.8
Latvia	-1.0	14.9	-0.4	12.4	-0.2	10.7	0.0	9.7
Lithuania	-1.5	19.4	-0.5	18.6	-0.5	18.2	-1.2	17.3
Luxembourg	-1.2	6.3	-0.1	6.1	1.3	6.6	2.9	6.8
Hungary	-6.5	59.4	-7.8	61.6	-9.2	65.6	-5.5	66.0
Malta	-4.6	72.6	-3.0	70.4	-2.6	64.2	-1.8	62.6
Netherlands	-1.7	52.4	-0.3	52.3	0.5	47.9	0.4	45.4
Austria	-3.7	63.8	-1.5	63.5	-1.5	61.8	-0.5	59.1
Poland	-5.7	45.7	-4.3	47.1	-3.8	47.6	-2.0	45.2
Portugal	-3.4	58.3	-6.1	63.6	-3.9	64.7	-2.6	63.6
Romania	-1.2	18.8	-1.2	15.8	-2.2	12.4	-2.5	13.0
Slovenia	-2.3	27.6	15.8	27.5	-1.2	27.2	-0.1	24.1
Slovakia	-2.4	41.4	-2.8	34.2	-3.6	30.4	-2.2	29.4
Finland	2.4	44.1	2.9	41.3	4.1	39.2	5.3	35.4
Sweden	0.8	51.2	2.2	50.9	2.3	45.9	3.5	40.6
United Kingdom	-3.4	40.4	-3.4	42.1	-2.6	43.1	-2.9	43.8

Source: Euro stat

[1] According to the Protocol on the excessive deficit procedure annexed to the EU Treaty, government deficit (surplus) means the net borrowing (net lending) of the whole general government sector (central government, state government, local government and social security funds). It is calculated according to national accounts concepts (European System of Accounts, ESA95).
[2] Government debt is the consolidated gross debt of the whole general government sector outstanding at the end of the year (at nominal value).

From the table data we can see that the excessive deficit procedure in practice gives results, because in almost every country the deficit figures are falling down. In this table we analyze the period from 2004 to 2007. In correlation of previous spoken this is used as overview for the current deficit and debt situation in the European Union. In 2007 the largest government deficit in percentage of GDP was recorded in Hungary (-5.5%), the United Kingdom (-2.9%), Greece (-2.8%), France (-2.7%) and Portugal (-2.6%). Opposite of that, eleven EU countries succeeded to achieve surplus in the budget in the same year: Finland (+5.3%), Denmark (+4.4%), Sweden (+3.5%), Bulgaria (+3.4%), Cyprus (+3.3%), Luxemburg (+2.9%), Estonia (+2.8%), Spain (+2.2%), Netherlands (+0.4%), Ireland (+0.3%) and Germany (0.0%).

As we saw from the table, almost every country with some exceptions is in favor of respecting the 3% deficit fiscal rule. While the other rule, about the public debt, is realized through the balanced budget rule in medium run. At the end of 2007 in Estonia (3.4%), Luxemburg (6.8%), Latvia (9.7%) and Romania (13%) had been noticed the lowest government debt to GDP ratios in EU. Opposite of that, countries like Italy (104%), Greece (94.5%), Belgium (84.9%), Hungary (66%), Germany (65%), France (64.2%), Portugal (63.6%) and Malta (62.6%) had the highest government debt ratios in 2007. From the statistics we can conclude that every country in EU tends to reduce their public debt ratio with exception of Italy, which debt is highest in euro area. These results show that surveillance and dissuasive part from the Stability and Growth Pact gave a positive and different approach in governance with the fiscal policies.

Stability and Growth Pact

Before we pay tribute to the fiscal criteria's, we'll shortly describe those two essential parts from the Stability and Growth Pact (SGP). The first step is the *surveillance part*, which main objective is to prevent countries from entering into excessive deficit procedure. Members of the Euro zone must submit Stability Programme with focus on the public finance - aim for achieving balanced budgetary position or surplus. Further these programs are revised by the Council in order to conclude if the country satisfies the necessary safety margins to avoid excessive deficit. Therefore if the country deviates significantly from the medium term objective, the Council gives a recommendation for future steps.[3] Second part of the SGP is the *dissuasive procedure*, it defines the excessive deficit as outrun of the referenced 3% value, except if it's exceptional and temporary (natural disaster or severe economic downturn-annual decline of GDP at least of 2%). If the decline is less of 0.75%, the country shouldn't use exceptionality of the deficit. On recommendation from the Commission, the Council decides if exists excessive deficit and recommends effective action from the country in period of four months in order to correct the deficit. If that doesn't lead to corrective action, there will be imposed sanctions upon the member country. In that case the country will have to make non-interest bearing deposit calculated through the following formula: $Dep=0.2+0.1(Def-3)$, where Def is deficit and other variables are expressed as per cent of GDP. According to the rules, if the country in period of two years doesn't correct the excessive deficit, the deposit is activated or turned in to a fine.

The criteria's for European accession are basic benchmarks for each country candidate for member. These conditions are already met by the countries members of the EU

[3] Commission of the European Communities, *The role of quality of public finances in the EU governance framework*, Sec (2008) 2092

and they are aware of the criteria's that constantly must be obeyed in order not to be subjected to penalties. All this is necessary, if the EU wants to have organized institutions through which it could realize her policies. When it comes in question the fiscal policy of the EU, it must be known that every country implements own national fiscal policy but in terms of following the benchmarks posted with the Stability and Growth Pact. With the Maastricht Treaty in 1999 were set rules (the 3% deficit and 60 % debt – fiscal norms) for conduct of the member countries and the countries with aspiration for becoming member countries of EU. This Treaty appeals to the Stability and Growth Pact as guide for national budgetary policies. First rule implies that countries must aspire to achieve balanced budget in medium run (over the business cycle). This is more restricted norm in comparison to 60 % debt. It means that the country shouldn't add new debt on the existing one over the business cycle. Secondly, the rule of 3 % budget deficit. This means that in worse case the country will be subjected to penalties for not following the European Commission suggestions. Germany proposal suggested that the countries be fined instantly after they breach the criteria from 3 % and face of with rejection from most countries. That's why European Commission sends warning to the countries which intend to break the rule before doing it and are given new opportunity to correct their direction in economic policy. Last case that turned on the public focus in Europe was United Kingdom, despite Hungary. That action was accepted with great embarrassment by their prime minister in the mentioned country. A third view of the Stability Pact includes some exemptions in case of higher powers i.e. natural disaster or decline of their GDP of more then 2 % during one year. When the drop of GDP is among 0, 75 and 2 % the country comes forward before the Council of Ministers to defend their justifications for exceptional deficit. Countries that suffered 0, 75 % drop in their GDP will not invoke exceptional circumstances. These conditions are elaborated in details in the Stability and Growth Pact framework.[4]

Arguments for fiscal rules

The enforcement of fiscal rules in budget policy is justified by following. First, the country with good intension of increasing debt - GDP ratio may cause pressure on the capital market by raising the interest rates, and therefore those of the government securities of the other union members too. In this case the irresponsible fiscal policy of one country may lead to restrictive fiscal policy in the other EU member countries, because the increases in interest rates will increase the burden of the other countries debt. That is why it's needed an instrument for budget restriction which will downsize the deficit. The second argument lights the pressure of the other member countries on the ECB demanding more relaxed monetary policy as a response to the uncontrolled fiscal policy of one member country.

Despite the relative truth in these arguments, they are denied. The first denial assumes that the capital markets are inefficient, which is totally unacceptable in developed integrated union. If one EU country has dynamic debt trajectory, that wouldn't necessesary mean pressure on the interest rates in other EU countries. The financial market will recognize the risk in the particular country government debt portfolio and will allow other countries to borrow at lower interest rate then the indebted one. So, if the capital markets are efficient, interest rates would be different in each country according to risk premium, and there wouldn't be reason for negative spillover effect.

[4] Paul De Grauwe, *Economics of Monetary Union*, Oxford University Press, Sixth Edition 2005

However, there is probability that lenders may step in, if they sense negative deep debt dynamic. The possibility of spreading out the financial crises through the financial institutions will be argument enough for bailing out the indebted country. Doing so appears problem of correct assessment of the premium risk that will be implemented in the interest rates. That is believed to be one of the essential problems for effective market functioning. That may be explained through purchasing government securities from that country by financial institutions from other member countries. In that scenario the negative implications will automatically reflect the other financial institutions, buyers of that government papers, and spillover the financial crises. The "bail out" guarantees that there is no place for panic and that the purchase of securities will lower the risk premium of the indebted country.

The second explanation for inefficiency of fiscal rules or argument for not enforcing them is the Gramm - Rudman legislation in USA, which set out explicit fiscal targets regarding federal deficit. According to that act, the spending had been cut in order to meet the legal targets. But that approach showed that not always the fiscal rules are considered to be 100 % efficient mean of controlling the fiscal policy, because there will be always someone who will try to bypass that legal obstacle, in the particular case - spending had been shown as item in the "off budget" account.

Public debt burden

After careful consideration of the budget deficit status in European Union and the arguments for implementation of the fiscal rules, it is inevitable shortly to point out the implications of the national debt. The national debt is the total amount of money that the government owes for goods and services but is never paid for. It is interesting that the deficit tends to increase the real GDP and the price level in the economy. The desire of these effects on short run is doubtful.

If the government runs budget policy of deficit, it spends more then it receives revenues. In order to fund the spending, the government needs to make a loan. That is usually done through issuing government bonds. In doing so, it competes with the private borrowers for money lent by savers, raising interest rates and causing "crowding out" effect on the private investment. Money is diverted from the private companies towards the government for funding budget deficit instead for investment.

However, there is also a "crowding in" effect. The government spending affects on the private investment behavior in a way that stimulates production of larger output in order to respond to the government demands. Therefore the private investor must invest in capital in order to increase its productivity. In this way the government stimulates the economy through this "crowding in" effect.

In the case of open economy, this kind of policy has impact on the exchange rate and the trade balance. In the case of expansionary fiscal policy, the high interest rate due to the government borrowing attracts foreign capital. The demand for domestic currency in order to invest in that country raises causing appreciation in the exchange rate. The appreciation makes the imported goods cheaper and the exported goods expensive in abroad, leading to decline in the trade balance. Since the foreigners sell more to the country than they buy from it, they acquire asset ownership in the country. This effect in the eighties was familiar as concept of "twin deficits" (budget and trade).

It is generally known that the “crowding out” is stronger than the “crowding in” effect. However, some delicate situations like economic downfalls request for “crowding in” effect as positive budget deficit policy measure.

This concept of government finance through indebting will have to be in some point of time replaced with the inevitable source – tax. So the debt burden is shifted to the future generations in sense of payment of higher taxes, all in order to be able to neutralize the negative effects of budget deficit.

Conclusion

In these modern times the government financing is considered to have more deficit oriented policy which through debt tries to secure money for the government spending. This manner of finance is realized with issue of government bonds. In this way the pressure on the private capital is enormous causing interest rates to rise and “crowd out” the private investments. Despite this source of securing money flow the government may use other not so popular instrument and that’s the enforcement of tax in order to increase the money flow from the revenue side. This paper through the analysis of the deficit movement in the member countries of the European Union provides a clear picture for the current fiscal policy in each country. According to that movement, the European countries strive to achieve balanced budget in medium-term, which on the other hand provides reduction in the budget deficit and public debt figures. Therefore, the implementation of the previously mentioned fiscal rules gives positive results in enforcement efficient fiscal policy in EU. For the first time from the seventies, it is noticed adequate desirable change in the fiscal policy of the EU countries, primary as result of the Stability and Growth Pact framework. After all the efficient implementation of the fiscal rules is the main reason for the current positive deficit and debt situation in the EU countries.

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