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The Role of Public Debt on Economic Growth, the Case of Albania

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Abstract: The global recession and the sovereign debt of European countries have triggered an intense debate over the effectiveness of fiscal policy and over the consequences of rising public debt. The relation between public debt and economic growth is a very studied and discussed debate. This paper aims to focus on some essential questions. A high public debt has a negative impact on economic growth? Does a low economic growth promote the growth of debt? What are the factors that affect the performance of these indicators and the mechanisms of transmission from one to another? The literature identifies two main lines: the Ricardian theory (or the Ricardian equivalence, under which the government debt is equivalent to the future taxes) and the conventional view (according to which the government debt stimulates aggregate demand and growth in the short term and promotes the reduction of capital and national income in the long term). What about the empirical data? The results are different in different countries and periods. What is the situation in Albania at about the last 25 years? Analyzing the macroeconomic situation and the main causes of a positive growth and a macroeconomic stability, but a high public debt, we can conclude over the expectations and the trend of the future.

Keywords: Economic Growth; Public Debt; GDP; Albania

1. Introduction

A stable economic growth is very important for any economy and of course for Albania, which, as a developing country intends to take steps forward to achieve the membership in the European Union.

On the other hand, equally important is the Public Debt, who can influence: the monetary policy, the international level of reliability, the political process, the capital outflows and the replacement of assets. It must be preserved under the level permitted by the EU (under 60% of GDP).

A government to find funds that are necessary for fulfilling its tasks has three economic tools: the taxes, the printing of currency and the public debt. The reasons why the government chooses the last alternative are: it would not be appropriate in a growing economy, that the current generation be taxed for goods, services or investments that would benefit a future generation; it is an efficient alternative for emergency expenditures; growth or continued tax cuts could lead to economic uncertainty; printing of currency may increase the money supply, interest rate and thus the inflation.

The economic growth and the public debt are two economic indicators that are closely related to each other, so it is interesting to study how the performance of one affects the other and vice versa. There is not a simple connection between them. There are many important factors for economic growth of a

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country and the performance of debt. Results achieved so far are different in different countries and periods, but how is the situation in Albania at about the last 25 years? By analyzing the macroeconomic situation and the main causes of positive growth and macroeconomic stability (in the last decade), but a high public debt, we can conclude the expectations and the trend of the future and draw interpretations and recommendations as to valid.

2. Purpose

The purpose of this study is to bring something new on this subject, unlike the current proceedings. As a phenomenon that has affected all of Europe, I hope that my study bring valuable conclusions on it. The study of public debt impact on economic growth will be carried out by analyzing the factors that affect the performance of these indicators.

3. Theoretical Relationship

Along the theoretical literature we can distinguish some views. Initially it will focus on the Ricardian argument and to the Conventional view.

In view of the Ricardian debt is regarded as a tax in the future. We are dealing with rational consumers and tax increases to fund the deficit is equivalent to own current account deficit. So, financing activities through tax budget deficit would not have net effect on national income in the long term. According to Ricardian equivalence, the timing of the tax change does not affect the type of consumer spending; being “taxed” more today than tomorrow, does not affect consumption. So, at a certain moment the choice to finance public spending through debt or through increasing the tax will not affect demand. (Emendorf & Mankiw, 1998, p. 35) (Barro, 1976, pp. 343-350)

From the conventional viewpoint, in the short term, public debt stimulates aggregate demand and economic growth, but in the long run stimulates the reduction of capital and national income. If the budget deficit is the result of constant spending and lower taxes, we have an increase of revenue to individuals. This will bring increased costs and aggregate demand. In the short term applies Keynesian theory where we have solid prices and wages. An increase in aggregate demand increases national income, which indicates a positive impact of debt on growth in the short term. (Emendorf & Mankiw, 1998, p. 13).

In the long run, the growth of public debt affects the reduction of national savings. It is valid the classical theory according to which in the long run we are dealing with flexible prices and wages. So the fiscal policy influences on the national incomes only by changing the offer for the factors of production. In this case, the public debt has a negative effect on economic growth.

The relationship between public debt and economic growth under conventional view takes the form of a U-destruction, known as Laffer curve. (Panizza & Presbítero 2013, p. 10)

Besides the above two viewpoints on the relationship public-debt growth, the literature shows that for classical economists, debt is regarded as a burden on society; by neoclassical economists as detrimental to investment and economic growth and by modern economists as a driver of economic growth if the funds are used for productive purposes.

4. How does Debt Affect the Economy?

Increasing public debt affects several factors, which then lead to GDP changes. First, the financing of this debt requires increasing capital and labor taxes and also brings a reduction in public investment. Raising taxes reduces the capital stock and reduces labor supply. The capital stock reduction could affect the reduction of foreign investment, while lowering labor supply could bring growth of the informal economy or tax evasion. There is a close link between trade deficit and the public one known as “twin deficit”. These factors affect negatively to GDP and economic growth in the country. (Cavallo, 2005)

Second, a country with a high public debt would have high interest rates and for reduce these, the central bank can pursue an expansionary monetary policy. This solution is valid in the short term, because in the long term, the interest rates will remain therein. Debt financing through monetary policy, as mentioned above, may be the main cause of a very high inflation. We are dealing again with a negative effect on economic growth.

Thirdly, if we analyze the impact on fiscal policy, we can say that the increase of debt differs public expenditure planning. If these expenditures will not be covered by taxes (fiscal entrances) consumers are less sensitive to public spending. The cost of debt service will be paid by the same consumers, but in future periods and they are more concerned about taxes than for public spending. Also, the government will show interest for the public spending, whose benefits are greater than their cost, to have the support of citizens. But generally the benefits are identified in the short term and the costs are prolonged in time, so the financing public expenditure through debt can be a good thing for the government who takes this commitment, but a big cost for the next government.

Fourth, the increase in debt can bring discounts to net national savings, thus increasing interest rates (which affect the reduction of investment and the reduction of the capital stock).

Finally, we should mention the effect on international relations. The investors consider taking debt as a measure of a country risk level, because it’s difficult for a country with a high public debt to face an economic crisis. In this case, their capital will be directed to countries with greater economic security and lower interest rates. Also, obtaining debt by another country or by an international institution reduces the autonomy of a country and affect its decision-making.

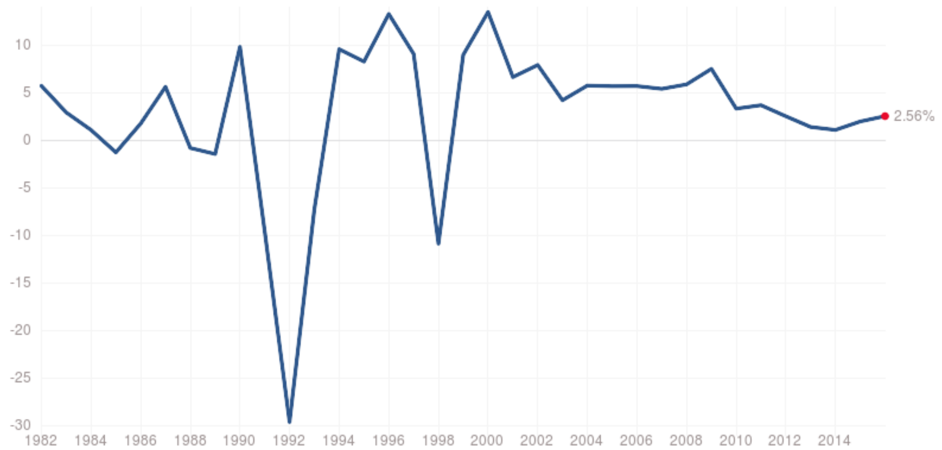
In conclusion, we can say that the public debt can affect the fiscal policy, the monetary policy, the capital outflows and the investment, the political process and the level of international confidence in the country. From this analysis, we can conclude that the public debt have a negative impact to the GDP and to the economic growth.

5. The Macroeconomic Situation in Albania

After a long period of isolation and a closed economy, after 1991 the situation in Albania began to change radically. The political and economic reforms have been effective, ensuring a stable economic growth. Referring to the IMF and the Albanian Bank, we can say that during the global crisis and the European one, in Albania we have had a low inflation, a sustainable banking system, a financial stability, thanks to a positive economic growth. These data indicate an appropriate fiscal and monetary policy and a macroeconomic situation without significant fluctuations.

In the years 2008 and 2009, we see a growth decrease, due to the impact of the global crisis (although small) and by the fact that Albania was linking relationship even closer with foreign businesses.

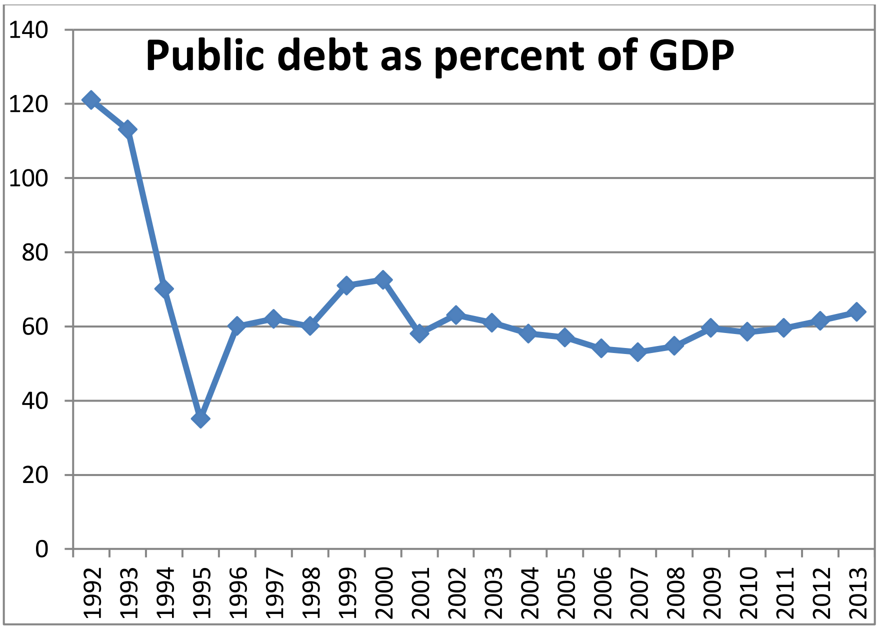
In Albania, the increase of public debt was mainly due to the need of funding public investments, focused on infrastructure.



Graph 5.1. Albania GDP growth rate per year

Source: World Bank > Albania > Albania GDP Growth Rate

Graph 3.2.



Source: Albanian Central Bank, Ministry of Finance, INSTAT

Referring graphs 5.1 and 5.2, let's analyze the public debt trend. During the years 1992-1995 we see a public debt fall as the reduction in public expenditure result and the capital account increasing. During the period 1995-1996 the debt increases, because the budget deficit reaches 11.2%. In 1996-2002, there is a deficit fluctuation and public debt one. The situation appears more stable in 2002-2012 (57.8% in 2010, 58.9% in 2011 and 60% in 2012). The situation is more worrying in recent years since the debt has increased by exceeding the limit of 60%.

What about the economic growth? We have had a steady increase over the period 1993-1996 averaging 9.2% per year; in 1997 the situation changed fundamentally as a result of pyramid schemes and the economic growth decreased by 11%; in 1998 the economy recovers achieving the highest growth; in 2000-2008 there is a consistency with an average rate of 6% and 2009 growth decreased reaching 3.3%; in 2010 economic growth was 4.1%; during 2011-2012 growth was positive; in 2013 we have a 1.5% increase, in 2014 an increase of 2.1% and in 2015 about 3%.

Regarding the relationship between public debt and economic growth during these years we are dealing with a negative relationship. There is a decline in economic growth when debt is growing and vice versa. The effect of changes in debt appears a few years late.

6. Conclusions

We can say that the main reason that affects the public debt growth is the budget deficit. For various reasons governments choose to finance the deficit through debt. Perhaps the best option to reduce the deficit and the debt would be the incomes growth and a proper tax system. Avoiding the tax evasion, the informal economy and the corruption we would change our deficit. Regarding the public spending is important a good and transparent use of the funds and for a productive purposes. The use of funds derived from the debt in the fields and sectors where the country needs, affects to the decrease of the negative impact of public debt on economic growth, as directly affect the welfare of citizens. So, the policymakers need to be more careful on the use of the debt and on how to decrease the budget deficit, if we want to preserve the public debt in the required limits. The restrictive policies during a recession are the reason for the negative relationship between debt and economic growth.

Analyzing the performance of public debt and economic growth in Albania's post-dictatorship, we conclude that there is a negative effect of public debt on economic growth (the conventional view). On the other hand, a limited economic growth has increased the budget deficit and the debt at the same time.

It remains a fact of particular importance the restructuring of public debt. This means: the determination of optimal debt portfolio, the assessment of current debt and the prevision of the effects of debt on other indicators.

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