

Public Financial Balance - Bases, Experiences and Trends

- Abstract -

Key Words: public financial balance, public financial imbalance, budget balance, budget deficit

Why This Theme; Theme Timeliness and Importance

In the current world economic context amplified by the economic crisis that began in 2008, whose major effects are still felt today, most countries in the world are facing large budget deficits and are forced to resort to taking drastic sometimes extreme steps.

On the other hand, it should be noted that there is still a possibility of Greece leaving the Euro Zone and chain (direct and indirect) reactions propagated by this decision may lead to the outbreak of a new world economic crisis, which could have even more serious effects upon national economies.

Last but not least, at European level, one must also take into account the economic consequences indirectly caused by the conflict in Ukraine.

Therefore, the theme approached herein ***“Public Financial Balance - Bases, Experiences and Trends”*** is extremely current in the global, European and regional economic and political contexts, as the deep knowledge of economic theory on public financial balance and the correct and timely implementation of adequate financial policies on achieving public financial balance, are absolutely essential elements of each country’s economic strategy.

Purpose of the Research

Based on the validated assumption that the increase in budget deficits beyond inflationary financed limits is an additional factor contributing in widening the imbalances in the economy, whereas the knowledge on public financial imbalance and the permanent concern with its continuous decrease are highly important elements, the more so as Romania has faced and is still facing difficulties in its economic changes.

Current Stage and Previous Research

The stage of knowing the research field is highlighted by the large number of research in this sector. There are many theoretical and empirical works of Romanian or foreign specialists, scientific researchers or teachers having much expertise in the field, whose opinions and arguments are of real importance. A number of economists have devoted part of their studies to

this sector of financial policy. The works of world-renowned researchers such as: *A. Smith, J.B. Say, D. Ricardo, T.M. Malthus, J.S. Mill, C.F. Bastable, P. Diamond, A.J. Auerbach, L.J. Kotlikoff, J.M. Keynes, B. Bernanke, A.S. Blinder, X. Greffe, A.T. Peacock, J. Weismann, A. Alesina, G. Tabellini, R.J. Barro, J. Buchanan, F. Modigliani, J.E. Stiglitz, P. Krugman, E. Helpman, J. Sachs, D. Cohen, W.M. Corden, R.A. Musgrave, P.B. Musgrave, M. Duverger, G.R. Lipsey, K.A. Crystal, T. Persson, G. Roland, R. Dornbusch*, as well as the works of Romanian researchers such as: *I. Văcărel, T. Moșteanu, D. Dăianu, E.-M. Dobrescu, E.M. Câmpeanu, G. Olah, M. Onofrei, I. Talpoș, D. Marin, L. Obreja Brașoveanu and many others*, have made up the theoretical and methodological basis of research.

The peculiarities of theories on public financial balance highlights that one can speak of two broad categories of theoretical approaches, namely:

- theories dealing only with the issue of public financial balance in the sense of budget balance;
- theories regarding public financial imbalance which deals with the issue of budget deficits.

Developing this Doctoral thesis has considered a thesis plan, using recognized research methods and highlighting numerous and relevant international and national studies, the work being a continuation of these efforts, within a unified approach.

Research Objectives

The main objectives of the thesis relate to:

- knowing economic theory on public financial balance (concepts, mechanisms, policies);
- identifying appropriate financial policies on achieving public financial balance;
- quantifying public financial balance/imbalance in Romania and conducting international comparisons;
- identifying the repercussions of the policies to achieve public financial balance on interest rates of state loans, current account and budget indicators;
- setting bidirectional causal relationships between budget deficit and current account deficit, namely between budget revenues and spending.

Research Methodology Involved

The research methods I have used in this thesis consist of a systemic analysis, a comparative analysis and a comprehensive approach of the researched topic, depending on the goals and tasks proposed. The methods and techniques used in developing this thesis include:

- *documentation*: theoretical documentation (books, national and international papers,

studies) documentation of the applicative part, processing and analyzing the information resulting from documentation, respectively logical and semiotic analyses of the concepts used, overall economic analyses, specific analyses, graphic descriptions of mechanisms and causal, structural and functional correlations among the variables involved in this study;

- *mathematical and statistical methods* such as: classification, synthesis, static and dynamic comparative analysis, correlation analysis, economic-mathematical modelling, methods of induction and deduction, graphical representation of events and phenomena investigated;
- *interdisciplinary research method*: research is based on knowledge from different fields of science and technology in economics, mathematics (economic models used), statistics, computer science (software used to process primary data);
- *investigation*: represented by the collection, systematization, analysis and interpretation of data;
- *econometric tests*: In Romania, I have econometrically tested the presence of twin deficit and the bidirectional causality relationship between budget revenues and spending during 2000-2014.

Structure of the Thesis

This PhD thesis has been structured and drawn up following a coherent and unified approach in four chapters:

The first thesis chapter – “***Conceptual Issues on Financial Policy and Public Financial Balance***” is dedicated to introducing the concepts of fiscal policy and public financial balance notions. As far as public financial balance is concerned, I have started from its original meaning as budget balance, up to the idea design focused on the importance of ensuring equality between public sector resources and needs, by resorting to state loans to complement budgetary resources. Next, I have aimed at showing the close link between public balance and imbalance, and also at highlighting the three types of public balances or imbalances that may occur during public budget execution, according to the relationships between budget revenues and spending. Finally, I have detailed the theorem of balanced budget according to which the budget multiplier is uniform regardless of the variables introduced in the models used.

The chapter on “***Theories on Public Financial Imbalance***” includes the main theories of public financial imbalance, namely: classical and neoclassical theories, Keynesian theories, Ricardian equivalence theory and modern theories (Ponzi scheme, Laffer curve of public debt, excessive indebtedness theory).

Classical theories estimate that the economic role of a state should be limited, since government actions generate waste and state loans are used to finance current consumption spending, leading to a reduction in economy revenues that could be effectively used by the private sector. On the other hand, public loans cause increasing difficulties in providing the necessary funding for the subsequent periods of time, as an increasing proportion of tax revenues will be used to pay public debt service obligations, thus leading to an increase in taxation.

In neoclassical theories, individuals are rational and insightful, having access to ideal capital markets and temporary deficits have insignificant effects upon consumption, saving, interest rate and other economic variables, whereas permanent deficits result in a lower capital accumulation. If consumers are under liquidity constraints, then the consequences of permanent deficits remain the same. However, temporary deficits should lead to a reduction in savings and an increase in interest rates.

In Keynesian theories, it is estimated that a significant share of the population has a bias towards higher consumption than disposable income. A temporary decrease in taxation has an immediate and significant impact upon aggregate demand. If economy resources are initially underused, then national income increases causing side effects. Given that public financial imbalance stimulates both consumption and national income, therefore saving and capital accumulation are not adversely affected. That is why, budget deficits would have beneficial consequences in the short term.

Ricardian equivalence theory or the theory of public debt neutrality, founded by economist David Ricardo, combines two basic ideas imbalance constraint represented by the constraint of public imbalance and the hypothesis of permanent income.

Ricardian equivalence is regarded as a theorem of public debt neutrality implying that the state reduces taxes and fees but without correspondingly decreasing public spending which, according to conventional analysis, generates a decrease in national saving and capital accumulation and, in the long term, a reduction of economic activity. Yet, this theory holds that such a policy does not affect consumption or capital accumulation. The Ricardian argument is based on the fact that the lower taxes and fees now and also the budget deficit because the level of public spending remains unchanged, generate an increase in taxation in the coming years. Thus, consumers looking forward do not react to lowering the taxes and fees by an increase in consumption, but save this surplus. Therefore, there is an increase in private savings, equivalent to the amount of tax reduction, whereas national saving does not change as well as other macroeconomic variables. These considerations have been the subject of numerous complaints which have led to a series of tests to verify the validity and relevance of the Ricardian equivalence theory.

The conclusions of tests performed reject public debt neutrality and prove that budget revenues (especially tax revenues) and debts that finance public spending do not have equivalent effects upon private saving and consumption.

Modern theories on public financial imbalance envisage the new theories designed to provide a number of solutions regarding state indebtedness resulting from internal and external borrowing, so that the effects upon the economy should be less discouraging or on a small scale. This issue of choosing between internal and external public debt has been suggested by the concerns regarding international debt crises and excessive public deficits. As a result, the following modern theories on public financial imbalance have arisen, namely: Ponzi scheme; Laffer curve of public debt; excessive indebtedness theory.

Ponzi scheme public assumes that public imbalance does not inevitably produce only negative effects. Instead, deficit is a game, an imprudent policy as it affects future generations who must bear a greater tax burden. The conclusion of this new theory is based on the study of economic growth rates and interest growth rates. Thus, if economic growth rate is higher than interest growth rate on public debt, then the state can finance and refinance its debt without increasing the taxes and fees in the future.

Laffer curve on public debt explains that the higher the public debt, the lower repayment probabilities.

Excessive indebtedness theory is based on the hypothesis that excessive external debt reduces the interest in investing in a debtor country. Therefore, this theory allows identifying those conditions where debt reduction stimulates investment in a debtor country.

In the next chapter – ***“Quantifying Public Financial Imbalance in Romania”*** I have sought to show both the traditional methods and the modern methods of quantifying financial imbalance. Unlike conventional methods for measuring conventional deficit, modern methods provide the techniques needed to size the following types of public imbalances: current account deficit; general consolidated deficit; deficit measuring the contribution of various governmental transactions in aggregate demand; national deficit; external deficit; situational deficit; structural deficit; cyclically adjusted deficit; actual deficit; primary deficit; operational deficit; quasi-fiscal deficit; virtual deficit; twin deficit.

I have also considered identifying the level of public financial imbalance in Romania between 2000-2014, starting from both the classical (budget deficits) and modern conception (budget deficits and debt taken by the state under special laws).

In the last chapter – ***“Macroeconomic Consequences of Policies to Achieve Public Financial Balance”***, I have analyzed the policies to finance and refinance budget deficit at present and the macroeconomic consequences of policies to achieve public financial balance

upon the interest rates of state loans, the current account and the budget indicators.

An important aspect of policies to achieve public financial balance is their impact upon trade synthetically represented by current account. Specialty literature has defined the so-called twin deficit expressing the simultaneous existence of budget deficit and current account deficit. Consequently, setting out trade policies, fiscal-budgetary policies, and policies to achieve public financial balance must take into account the existence and direction of the causal relationship between budget deficit and current account deficit, which are the arguments that have led the author to econometrically test twin deficit in Romania.

Additionally, the policies to achieve public financial balance exerts a direct influence upon budgetary indicators, too. On the one hand, the cost generated by these policies represented by the interests and other costs related to state loans for financing and refinancing budget deficits and state debt under special laws, is reflected in the total budget spending, namely in current expenditures. The level of such expenditures is influenced both by the interest rate at which the state borrows the capital required to cover its needs and by the maturity of such loans.

Furthermore, the influence of policies to achieve public financial balance is felt directly in the level of budgetary revenue and spending not only by the interests on state loans, but also by the changes that may occur in these indicators meant to ensure the budget deficit within sustainable limits. In this case, I have thought it necessary and appropriate to carry out a series of econometric tests to identify the causal relationship between budgetary spending and revenue.

Research Results

The scientific results of this research mainly consist of: the systematization of concepts and theories on public financial balance/imbalance; the introduction of a thorough analysis on the public financial balance in Romania (deficit/public national budget surplus, deficit/general consolidated deficit surplus, deficit/primary surplus, deficit/operational surplus, deficit/structural surplus, quasi-fiscal deficit, current deficit, capital deficit) and the international comparisons in order to identify Romania's condition in particular to the countries of the European Union with regard to meeting the convergence criteria in order to access the Euro Zone; outlining the policies of financing and refinancing budget deficits; the introduction of a detailed analysis of the macroeconomic consequences of the financial policies to achieve public financial balance in Romania (consequences on the interest rates of state loans, on current account and budget indicators).

It should be noted that researches have been disseminated and presented at international conferences and in papers indexed in international databases and Romanian specialty reviews.

Limitations of This Research Thesis

As any scientific research, this paper, too has some inherent limitations, but I think they have no significant effects on the findings of studies and analyses. Some of these limitations are: the dynamics of the topic discussed, the magnitude of specialty literature, involving a subjective synthesis ability; the gap of data on budgetary indicators being officially issued, due to the complexity of the calculations needed for that purpose; the different methodologies to calculate budget deficit which cause difficulties in making international comparisons; space and time dimensions which have distinctly influenced the economies analyzed (without ensuring a constant correlation between the two dimensions in the phenomena occurring in these economies).

This work does not attempt to find solutions to all the issues involved in the analysis because such an objective would not be realistic. Of course, finding some answers to existing economic theories on public financial balance generates other questions that need to be analyzed in the future so that new research topics emerge.

Work Completion (Conclusions, Author's Personal Contributions and Further Developments)

According to the structure this thesis, conclusions and personal contributions have been included in the end of each chapter, and also in the end of the thesis. With no claim to have drawn up an exhaustive work, still I believe that I have been able to draw some guidelines which will subsequently be analyzed in-depth, representing a challenge that bears developments and additions from interested parties.

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