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Unsustainable deficit spending and its implications under full economic integration

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Abstract: Governments that have practiced unsustainable deficit spending over several decades have generally ended up with their respective economies being on the verge of collapse particularly when access to financing is cut. Bailout packages may be granted by multilateral financial institutions but will also require austerity measures that impose more taxes, cuts on government spending, larger appropriation for debt payments and privatization of government assets which threaten to further choke an ailing economy.

The objectives of the study are to illustrate the consequences of unsustainable deficits and public debt and how it will affect full economic integration. The methodology used is the descriptive approach which presents the experiences of severely indebted countries in Latin America and Western Europe.

Initial results indicate that the formation of an economic union promises more trade and investment among member countries and creates one large integrated market with the free movement of labour, capital, goods and services and the use of a common currency. However, a member country which aggressively practices deficit spending as a means of pursuing economic growth, job creation and the provision of massive welfare benefits may actually test the limits and go beyond sustainable debt levels particularly if a common currency will facilitate lower cost financing through a Central Monetary Authority in an Economic Union.

It can be concluded that deficit spending should not be treated as a policy without severe consequences in the long run and that loans or bailout packages granted by international financial institutions will only delay but cannot stop an inevitable collapse caused by unsustainable public debt.

Key words: Unsustainable public debt and deficit spending, economic collapse, hyperinflation, fiat currency, government bonds

1. Introduction

The existence of big government may allow for the provision of more infrastructure, social services, welfare benefits and large levels of public sector employment, but all of these above mentioned programs exist only because resources have been taken from the private sector through the use of excessive taxation. The creation of real wealth can only be attributed to the private sector that creates this wealth through the production of goods and services to be exchanged in free markets. The only reason why government is able to exist and function is because of its coercive ability or the use of force to extract tax payments from the productive private sector . Without a private sector creating wealth, government will not have any resources to take and redistribute. Government depends on the private sector for tax revenue, but the implementation of excessive and often times oppressive taxation discourages initiatives to either create or expand business enterprises that produce real goods and services and leads to private sector investments searching for other new and freer markets which have less oppressive tax policies.

Big government will require greater tax revenue, but in view of the negative effects of more taxes and higher tax rates on the productive members of the private sector, the use of deficit spending becomes a practical strategy for facilitating the operations of big government. Deficit spending allows government to implement more programs using larger government expenditures despite a substantial lack of tax revenues to finance it. This can be accomplished with the use of: a Central Monetary Authority (or a Central Bank) that has the power to create unlimited amounts of fiat currency; government borrowing from the private sector and; foreign borrowing.

Objectives

The objectives of the study are: to establish the link between unsustainable debt, hyperinflation and severe recessions; to extract insights from the experience of severely indebted countries which manifest characteristics similar to those of the Philippines and; discuss the implications of unsustainable debt under full economic integration.

2. Methodology

The study uses a historical and descriptive approach in establishing the causal relationship between unsustainable debt, hyperinflation and severe recessions. The historical experiences of severely indebted countries is discussed alongside the identification of insights and policy lessons that can be relevant to the Philippines as it participates in the completion of the ASEAN Economic Union.

3. Initial Results and Discussion

3.1 Central Bank Financing Fiscal Deficits

A government which does not have enough tax revenues to finance its programs simply issues debt instruments in the form of bonds to be sold to a Central Bank which uses this as a basis to create new fiat currency that becomes a loan to finance the government's fiscal deficit. This practice of monetizing public has allowed government to continue spending beyond its means without having to immediately tax the private sector. Firms and workers do not notice tax rates rising or new taxes being imposed, but instead get to observe rising prices for goods and services which is the actual consequence of money creation that finances excessive government spending. Rising prices or inflation is actually a hidden tax shouldered by firms and households. Government is able to undertake excessive spending despite the lack of tax revenue because of its access to new money created by the Central Bank. The newly created money which flows into the economy will have the effect of diluting the value of existing money currently in circulation. As more money circulates in the economy, households, firms as well as government are now competing for almost the same amount of goods and services which puts pressure on prices to increase. Fiat currency further loses its purchasing power, leading to a reduction of

living standards particularly for fixed income earners.

The inflation attributed to monetizing public debt becomes a hidden tax because the accumulated fiscal deficits which lead to an accumulation of public debt will ultimately be paid by more taxes and higher tax rates in the future. The Congress and the Senate will attempt to pass legislation on new taxes and higher tax rates gradually, over a long term period in order to avoid violent opposition from the private sector. Thus deficit spending hurts the private sector through higher prices of goods and services, the currency's loss of value and more taxation in the future. This welfare loss for the private sector is magnified by the fact that government funds from taxation are diverted into the private bank accounts of government officials through project commissions, kickbacks or worse, government projects approved as proposals , but were never implemented despite the release of funds by the executive branch. Taxation becomes theft as a portion of the private sector's income is coercively taken and redistributed to government officials.

Governments that have practiced unsustainable deficit spending over several decades have generally ended up with their respective economies being on the verge of collapse particularly when access to financing is cut. The growing prospect of government defaulting on its obligations leads to the issuance of bonds with unreasonably high interest rates that slows down an economy to the point of inducing a recession. As a recession becomes deeper, firms close down, unemployment worsens, civil unrest grows and the clamour for more government support and safety nets becomes stronger. The extent of civil unrest grows to the point that street protests are accompanied by massive looting and riots. Peace and order breaks down because of the absence of law enforcers affected by budget cuts. This puts more pressure on a government already deep in debt struggling to find investors for its risky bond issues that will finance its deficits.

3.2 Hyperinflation as an outcome of currency creation

In the absence of foreign buyers of government bonds, monetizing public debt becomes the next desperate option as these bonds are sold to a Central Bank which issues new fiat currency to help finance the deficits. For countries with unsustainable deficits and debts, hyperinflation becomes the outcome, which induces panic among households and forces capital to escape to more stable countries. Governments initially attempt to address the problem by printing more fiat currency at a faster rate but this approach only makes the hyperinflation much worse leading to a currency collapse and the public abandoning the local fiat currency. Economic activity further declines, unemployment increases, workers are evicted from their homes, civil unrest worsens and the unemployed protest on the streets. Over the past several years countries such as Germany, Austria, Hungary, Argentina, Chile, Bolivia, Brazil, Yugoslavia, Russia, Ukraine, Greece and Zimbabwe have all experienced hyperinflation at one time or another attributed to their unsustainable debt and deficit spending practices.

After losing World War 1, the German economy had experienced hyperinflation that had reached 1 trillion percent from 1924 to 1925 caused by excessive deficit spending and funded through the creation of more domestic currency (the German mark) by its Central Bank . It is common for countries suffering from hyperinflation to increase the rate at which money is being created alongside increasing the denominations of paper bills with Germany having the largest denomination at 100 trillion marks. The economy of Zimbabwe experienced 89.7 sextillion percent inflation in November 2008 also attributed to a government that had abused deficit spending practices in cooperation with its own Central Bank. Its domestic currency had a largest denomination in the form of a 100 trillion dollar Zimbabwe note. Greece had hyperinflation of 8.5 billion percent from 1942 to 1944, Bolivia had 20,000 percent in 1984 to 1986, Argentina at 4,923 percent in 1989, Brazil at 2,075 percent in 1994, Chile at 1,200 percent between 1971 to 1973, Russia at 2,520

percent from 1992 to 1994, Austria at 1,426 percent from 1921 to 1923 and the Ukraine at 1,400 percent from 1993 to 1995 (Mankiw, 2012).

3.3 Ratio of Public Debt to GDP

Countries which had accumulated fiscal deficits and enormous public debts and are currently on the verge of a severe recession have public debt to GDP ratios larger than 60 percent. The European Union has eight (8) countries in this predicament namely: Greece at 161.3 percent in 2012 and projected to be at 182 percent by the end of 2016, Iceland at 118.9 percent, Ireland at 118 percent, Italy at 126.1 percent, Portugal at 131.1 percent, Spain at 85.3 percent, Belgium at 99.6 percent and France at 89.9 percent. These countries have adopted massive deficit spending practices and have been able to get more access to financing from the European Central Bank immediately after a common currency was adopted and their respective domestic currencies replaced. Common among these countries is the existence of a government which provides welfare benefits on a massive scale. Big government becomes the largest employer and provider of public health, education, housing, social security and other social safety nets aside from the conventional role of providing infrastructure, national defence and security, and law enforcement.

For the year 2014, youth unemployment in these countries have increased substantially with Belgium at 22.4 percent, France at 24.6 percent, Greece at 51.1 percent, Spain at 51.7 percent, Ireland at 21.9 percent, Italy at 42 percent, Iceland at 9.7 percent and Portugal at 33.3 percent (Eurostat 2015).

The 2014 overall unemployment rates for these countries are: Belgium at 7.9 percent, France at 10.2 percent, Greece at 24.5 percent, Spain at 20.8 percent, Ireland at 8.8 percent , Italy at 11.4 percent, and Portugal at 11.8 percent.

In 2014, economic growth for Belgium was at 1.3 percent, France at 0.2 percent, Greece at 0.7 percent, Spain at 1.4 percent, Ireland at 5.2 percent, Italy at -0.4 percent and Portugal at 0.9 percent (IMF, 2014). Unsustainable debt slows down and in certain cases stops economic growth as deficit spending is cut back because of the difficulty of finding buyers for government bonds.

When debt becomes unsustainable, government experiences difficulty borrowing funds to finance deficits and pay-off maturing debts. Interest rates have to be increased in order to make government bonds more attractive because of the greater risk of default. Higher interest rates discourage private sector borrowing which further slows down economic activity. If deficit spending cannot be undertaken as the economy slows down, government workers lose their jobs, pensions cannot be paid, public schools and hospitals close down, police and firemen are laid off, leading to riots, looting and a general breakdown of peace and order. Bail-out packages in the form of new loans from the European Central Bank and the International Monetary Fund can temporarily generate some short term growth but cannot stop the inevitable economic collapse as debt defaults occur and deficit spending grinds to a halt.

3.4 The inefficient nature of government

Politicians interested in getting elected promise more benefits to their respective constituents in the form more government jobs, larger pensions paid from a public social security system, wider coverage under public health care, increased access to public education including scholarships and stipends at the tertiary level, food stamps and other food distribution programs for the unemployed, unemployment insurance for workers who had recently lost jobs and cash transfer payments for households struggling to get out of poverty. These promises are made by politicians running for office under the executive and legislative branches of government without regard to the tax payers in the private sector who will end up shouldering the cost of all these welfare programs. Deficit spending whether financed by government bonds or foreign loans guarantees that recently incurred public debts will be paid by the imposition of new taxes and higher tax rates

imposed through a gradual introduction of new legislation. Government always gives the impression that public debts may be adjusted to manageable levels and a fiscally sustainable position can be maintained, but hardly any attention is given to the fact that the most productive members of the economy that create wealth and who are in the private sector suffer from the lost ability to improve living standards and expand productive capacity as government coercively takes their hard earned income and redistributes this within various government units which do not produce any wealth but remain dependents of the private sector. The burden of taxation is fully shouldered by the private sector. Taxes paid by government workers do not come from the creation of new wealth but are merely the redistributed tax payments (in effect transfers) coming from firms and workers of the private sector who made it possible for government to spend for job creation.

Government operations cannot be expected to be efficient, and big government just provides an opportunity to increase the magnitude of inefficient and wasteful use of resources being siphoned out from the private sector. More often than not, government functions as a monopoly and in the absence of any competition from the private sector, will never be responsible for its wasteful use of resources. Government agencies and government corporations do not absorb losses in the way private firms do. Firms in the private sector suffer losses and close down when operations are inefficient, when average costs are high and the quality of products and services are poor and uncompetitive. Government agencies and corporations do not shut down despite losses, high operational costs and the poor quality of products and services because of subsidies and bailout packages financed by taxpayers. Private firms are forced to improve product quality and services in competitive markets in order to improve sales and profits and remain financially viable. Government is not forced to behave in this manner because its operations cannot be shut down and can always be subsidized or bailed out. The moral hazard problem is magnified by government in its various operations because, as long as the tax payer shoulders the cost of government, public officials can continue with wasteful and irresponsible spending without having to worry about being shut down.

Government budget proposals are always bloated/ overstated not only because of inflation assumptions that are supposed to account for higher costs, but more for the purpose of overpricing projects in order to collect larger commissions and kickbacks. In the event that a project is not implemented, legislative measures ensure that unspent budgets are converted into public savings subject to reallocation for other government expenditures including its distribution as year-end bonuses to staff and other personnel or for pork barrel funds subject for reallocation as development projects for political allies in the legislature.

3.5 Deficit Financing under a Regional Central Monetary Authority

The practice of deficit spending is expected to get worse particularly if a severely indebted country is allowed to participate in an economic union. This becomes possible as the debt ridden country's domestic currency is replaced by a common currency which will be controlled by a Central Monetary Authority within the region. If the currency of a debt ridden country has practically lost its value because of excessive money creation by its domestic Central Bank, there will be an incentive to participate in an Economic Union in view of the greater access to a new common currency whose purchasing power is stronger and can be utilized for more public spending and importation. This was the experience of the Greek Economy when its local currency ,the Drachma was replaced by the Euro upon the formation of the European Union.

The unhampered movement of goods and services caused by the reduction in tariff rates, elimination of quotas and reduction of non-tariff barriers among European Union member countries, along-side the removal of restrictions in the flow of labour and capital within the region increased the amount of trade and investment that occurred among the member countries. The European union becomes a

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large integrated market with unrestricted flows of trade and investment including portfolio as well as foreign direct investments. European Union members such as Greece, which had huge fiscal deficits and public debt initially got access to euro funds at lower interest rates from the European Central Bank. Greece had an incentive to accept the euro as the common currency since its former currency (the Drachma) was subject to substantial losses in value (because of inflation) , while interest rates on government bonds under the old currency regime were unusually high ranging from 25 to 31 percent. However, financing from the European Central Bank allowed Greece to borrow euros at much lower single digit interest rates, further encouraging deficit spending. The Greek economy had big government responsible for providing employment for a large share of the labour force, very attractive pension packages for retirees, and enormous benefits in the form of public housing, health care, education and social safety nets in the form of unemployment insurance and state food programs.

As Greek politicians promised more welfare benefits in the form of government jobs, large pensions, more public housing, healthcare and education, government deficit spending became substantially larger going beyond sustainable levels which required more foreign financing from the European Central Bank. The credit rating of Greece remained acceptable as long as it could avoid defaulting and continue to pay-off maturing short and medium term obligations as they become due. However, the payment for maturing obligations where still taken from borrowed funds originating from the European Central Bank and other international creditors. When the 2008 financial crisis of the United States spread throughout Europe particularly through the sale of financial derivatives and sub-prime mortgage backed securities, the Greek government lost access to financing as the contagion led to commercial bank failures in Europe and the European Central Bank decided to suspend all forms of credit extension until the crisis could be addressed. This became catastrophic for the Greek economy as it lost access to financing to settle maturing obligations and funding for its fiscal deficits and big government welfare programs.

4. Conclusions

The formation of an economic union promises more trade and investment among member countries and creates one large integrated market with the free movement of labour, capital, goods and services and the use of a common currency throughout the region. However, a member country which aggressively practices deficit spending as a means of pursuing economic growth, job creation and the provision of massive welfare benefits may actually test the limits and go beyond sustainable debt levels particularly if a common currency will facilitate lower cost financing through a Central Monetary Authority such as the European Central Bank. This is the experience of Greece, which currently has unsustainable debt at 175 percent of its national output accumulated over four decades of persistent deficit spending. The Greek economy is now on the verge of collapse, hoping for new loans or a bailout from the European Central Bank, the International Monetary Fund and the World Bank. Austerity measures that involve the imposition of more taxes, cuts on government spending, automatic appropriation for debt payments and privatization of government assets are conditions being imposed as part of a bailout, but in the long run threaten to further choke the Greek economy and prevent recovery. Deficit spending should not be treated as a policy without severe consequences in the long run. Loans or bailout packages granted by international financial institutions will only delay but cannot stop an inevitable collapse caused by unsustainable public debt.

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