# WAYS OF GOVERNMENT INTERVENTION IN "MANIPULATING" THE PERCEPTION ON PUBLIC DEBT

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*"This deficit is no despised orphan. It's President Reagan's child, and secretly, he loves it. The deficit rigorously discourages any idea of spending another dime on social welfare".*

New York Times, 1987

**Abstract**

The increased level of public debt along with debt crisis happening in many countries worldwide has attracted the attention of several researchers, not only in terms of fiscal policies sustainability analysis, but mainly in terms of the role of different political government decisions contributing in the enlarge levels of public debt. Keeping in mind that fiscal policies are nothing else than a pure reflection of government programs, even the capacity of a country to borrow should be perceived as a message of the latter to undertake rights or obligations at any time. Some countries can afford higher levels of debt comparing to their current level of indebtedness which is a result mainly because their government clearly express their readiness to use debt as a way of financing only in specific situations. In this context thearticle objective is to provide an overview of how government affects the size of public debt in the economy not only through its program, but also by using other means such as economic concepts of fiscal illusion or hidden debt without denying their good intentions and initiatives undertaken to limit public fund abuse which is expressed in their willingness to establish fiscal rules, followed by an overall analysis of Albanian debt situation stressing outall the contributing political attitudes.

**Keywords:** *public debt, government program, budget deficit, fiscal illusion, hidden debt*

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**I. Principles of government political program and correlation with public debt**

Government vision plays a crucial role in determining the level of economic development and sovereign debt in the country not only for their years of mandate but for many other decades later. Thus public budget which is the financial plan that represents in the best way government programs and ideologies reflects the level and composition of public spending in response to the gratitude and reward of their electorate. Thus, it is known that the left parties embraced a philosophy which makes them more inclined to allocate government spending mainly for education and social protection activities, while right-wing parties are more concerned for investments that promote developments on industrial and services sectors that protect individual capitals and undertake fiscal policy targeting the inflation reduction. Furthermore, according to Potrafke (2010) the party that will be in power will bring major changes not only in the tax policies that will be applied in the future, but even in the way of income distributions, in addition to the estimation of public goods available to individuals as well as the size of deficits and public debt. In this way the ideologies of each party signal and influence individuals to vote them in the future. While the highest misleading effects that the government cause in terms of mismanagement of public funds and on the debt accumulation at high levels occur primarily in pre-election periods, in order to produce more favorable conditions for persuading the electorate for their re-election. According to Grilli et.al (1991), political systems inherited through years and electoral processes both impact the ability of the government to handle accumulated deficits and debts that grow continuously. In these cases, what matters is the life expectancy of the ruling political force, and therefore very short-term visions governments do not take decisions or actions related to project whose impact and visibility are not short term, but on the other hand these projects couldbe very important for stimulating economic development of the country. Alesina and Tabellini (1987) argue that, in democratic countries where free electoral processes are established, different preferences on fiscal policy makers are directly reflected on the level of sovereign debt, which the governments use as a strategic variable to influence elections and also as their ways to put constrains for subsequent governments. Thus, if there is disagreement between the political forces and no consensus on the composition of government spending between activities and the benefits of the services to be provided the economy will have higher levels of deficits as a result and debt equilibrium level will be as high, as the degree of political polarization. This argument shed light on and justify differences in debt accumulations between different countries because of government initiatives or and their administration way of spending on convincing the electorate. Besides preferences and ideological differences between political forces in the country there are other elements that justify the evolution of the debt associated with institutional systems in place along with party systems which can be majoritarian or proportional. Roubini and Sachs (1989) verified the tendency for higher deficits in countries where the government is "weak". Feature of weakness are mostly related to government long life and size of the coalition so if they are created or not as a result of many political parties. These facts are confirmed even byKontopoulos and Perotti (1999), Feld et.al (2004), but in their study another important factor along with the coalition size is also the size of the cabinet, so the number of ministers with portfolio in a cabinet. The larger the number of ministers with portfolio, the higher the level of expenses incurred and the higher the level of debt in the country, especially in periods when the macroeconomic situation are extremely volatile.

**II. Fiscal illusion and hidden debt**

In a democratic society resource allocation between public and private sector is clearly defined by the desire of the electorate, but since the accurate determination of this distribution is a voluminous duty which requires a lot of time mainly in selecting the appropriate political information “produce” constantly uninformed individuals on the costs and benefits that everyone receives from the government in power or will benefit from future governments. This kind of "ignorance" says Downs (1960) makes governments to adopt smaller budgets than those that would have to approve in cases individuals would own all the necessary information. This imperfect information constitutes the essential condition for the existence of the economic theory of fiscal illusion, which is nothing more than a systematic misinterpretation and misunderstanding of fiscal parameters related to the nontransparency of taxes and debt burden besides the level of public expenditures that the government undertakes. In this context (Oates, 1988), the government underestimates the costs of political programs and increases up to exaggerating their benefits. The tax system is one of the key elements and the most notable fiscal illusion which includes various forms of taxation of vague and complex models to preserve as secret the real costs of public programs.

However, not randomly more recent empirical literature focusses on fiscal illusion mostly on the revenues side that consists on tax model and debt burden and their hidden elements. The main argument in such cases involves selecting between financing through taxes or debt, which is more affected by the way individuals perceive costs of each of financing way, more concretely today or tomorrow taxes. Debt illusion in this case means that individuals are not attentive to their part of the obligations represented by the level of debt in the country and which constitutes a collective decision. Certainly that for rational taxpayers based on the Ricardian equivalence theory wouldn't make any difference between debt and taxes, but the main assumption here is related to the fact that "debt illusion is presented at a time when the taxpayer tends to underestimate the present value of future tax liabilities as a result of debt financing because the lack of knowledge even for the total amount of the transaction enable this. The experience shows that reliance on debt financing as a way tends to result in public budgets larger than those declared in the case of financing through taxes. However, according to Buchanan (1967), opting for the debt financing can be a rational choice depending on the expectations of everyone‘s perception onhis life limitations. If individuals would believe that they would die soon, they are not going to make calculations, but they simply wouldn't choose taxes, that should be paid immediately. Illusion in this case has to do more with individual assessmentswhich underestimate subjective costs versus funding method. While Puviani (1967) in his theory explains that the philosophy of the illusion of public debt used by policymakers is of another form. According to him, individuals will underestimate the use of debt not only because of the asymmetric information, but because they cannottreat in the same way obligations that would reduce their total wealth now and in the future. The fact that the debt is "embodied" as an annual fee to infinity alters individual wealth which cannot be assessed instantly. On the other hand according to Dalagamas (1993) debt illusion implicitly is considered as an extension of *individual private net wealth.* This is mainly due to the perception that a low tax for public goods will boost purchasing power for private goods maybe at a cost equal to the lowest level of savings made. Thus, in countries where the level of debt to GDP is low, the government has no reason to draw the attention of the public regarding the consequences of financing through long-term debt.For this reason private agents tend to exhibit consumer behavior in accordance with the theory of illusion, the reason that encouraged Keynes to support debt use for stimulating economic development. While in countries with high levels of debt, the government informs the electorate carefully about the negative effects of it through the execution of fiscal policies that favor tax financing. Finally, the researchers argue that the use of debt illusion, is mainly a result of country-specific characteristics such as economic conditions or institutional features (Chang.et.al, 2013) that can be the root of different behaviors that lead to the disguise of the government spending's. Thus in general, countries with high levels of debt are driven to making expenses without declaring them in public. While countries with high credibility in international financial markets would found the disguise of public spending and of public debt very difficult and costly. Even though government budgets are complex statements and difficult to interpret, policymakers lack the willingness to draft them in a more easy and transparent way because they also prefer to keep away a part of this information from detailed analysis of the public. These factors enable the concealment of the real level of public debt thus undermining macroeconomic and fiscal performance. IMF and World Bank have undertaken a series of studies to describe the various ways by which governments can hide their obligations, judging full fiscal transparency as a phenomenon that rarely happens in reality. Thus, governments through the use of extra accounts can left out deliberately a part of the obligations and assets from the official statistics. However, these real liabilities of the government that do not appear as part of the official debt declared are transferred to lower levels of government such as special funds, local governments or public agencies. Internal or external pressures to keep debt at low levels serve as initiatives to hide indebtedness levels. Such political and electoral pressures are higher in election periods when the management of public funds is very weak despite the rules and restrictions accommodated as a way of auditingfrom international organizations.When these restrictions are not audited as it might need and are focused mainly on fiscal measures governments found much easier to overcome them through the techniques of hidden debt, especially if the state is institutionally weak. While when these auditings are perform in regular basis in long term, governments pay more attention to manage levels of public expenditures.

**III. Legal restrictions and fiscal rules role**

The rapid growth of budget deficits and public debt in many countries emphasized the importance of (re) establishment of legal restrictions and the application of different fiscal rules. These rules imposed by governments should be simple and easy to materialize and to be communicated with the public establish some numerical objectives in long term to run an effective fiscal policy that avoids mistakes of various governments' governance. According to the IMF (2009) these legal restrictions initiated in the 19-th century, and were imposed mainly to local governments or federal states, while after World War II, many countries such as Germany, Italy, Japan and the

Netherlands incorporated these rules to balance their budgets. During 1970-2000 many state governments set even more rigorous restrictions. In the US was legally implemented Gramm-Rudman Act that was replaced later with Budget Enforcement Act; while in Canada it was approved the Expenditure Act and Federal Controls. European countries on the other hand implemented rules imposed by the Maastricht Treaty in establishing procedures on limiting deficits and debt levels. Recent acts were drafted with the justification and the need to limit any state governments to undertake fiscal policies in accordance with Economic Monetary Union until the establishment of fiscal rules drafted by the European Commission. All fiscal rules restricts or predetermine in a direct or indirect way deficits and public debt limits, but on the other hand they should be reliable in order to provide public finances sustainability. Four main types of fiscal rules can be distinguished which were firstly introduced in countries suffering high levels of debt per capita.

***Balanced budget rules***, which can be specified as rules that ensure a general balance or structural balance cyclically arranged to enable the level of debt to GDP at finite levels. Primary balance rules can be included in this type of rules which appear not that much linked with the debt sustainability, besides the “Golden Rule” used to maintain the balance of net capital expenditures versus current expenditures.

***Debt rules,*** explicitly set a ceiling limit or a target debt to GDP level. This type of arrangement is accepted as one of the most efficient provisions to ensure compliance with the target level of debts. However, in cases where debt level of GDP is below the pretedetermined levels, these rules do not serve as a guide for fiscal policies that should be followed in the future. Rules imposed as a result of the Maastricht Treaty that set the level of debt to GDP at 60% and the level of deficits to GDP at 3% are examples of debt rules.

***Expenditure Rules***, usually define sustainable levels of public spending in total, powered by restrictions on their growth rates from one year to another as well as in establishing discipline in current expenditures not only in absolute terms but mainly as percentages of GDP. These rules are not linked directly to the debt sustainability objective but still they serve as an operational tool to achieve fiscal consolidation of the economy.

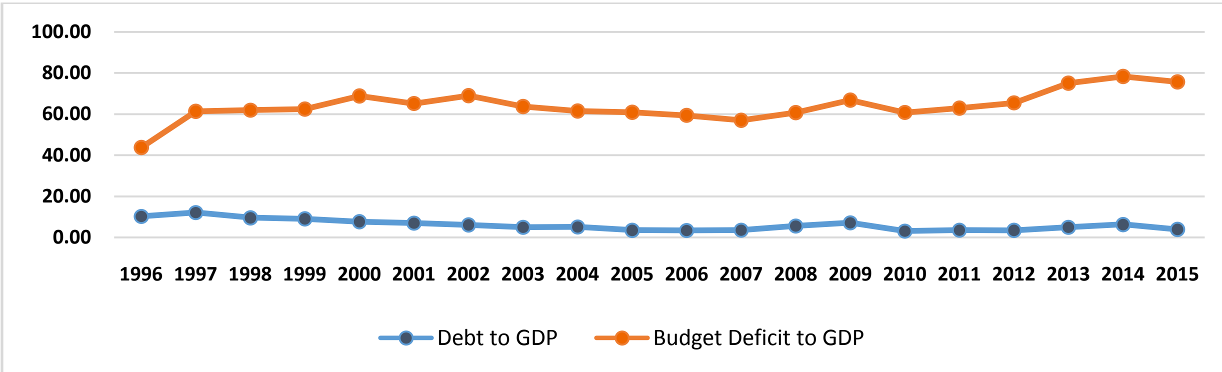
***Revenue Rules***, are designed to fix floor /ceilings levels of income in order to promote their collection to prevent the growth of the tax burden. These rules doesn’t control explicitly the level of debt but that still they support the debt sustainability because of limits they impose in taxes and also on preventions of procyclical nature of expenditures.

However, literature considers as fiscal rules not only numerical limitations described above, but also the limitations imposed to reduce the number of revisions of annual budgets especially on the expenditures side. In general, countries apply combinations of fiscal rules, because each of them separately is not capable to support economic sustainability. Thus it is proved that a significant factor that affects the level of sovereign debt in an opposed direction is the level of centralization. That is why legal acts regulating maximum allowed limit of guaranteed debt must be imposed even for local governments. Despite the legal barriers and fiscal rules enacted which should serve as “umbrellas” to maintain financial stability in the country, experience has shown that their efficiency has not always been at desired levels, because of the bureaucracies required for their implementation (Kopits, 2001). Moreover these rules may ruin political discussions since in elections the most discussed subject is the level of expenditure that a political force would undertake, deciding somehow for the future level of deficits and sovereign public debt.

**IV. Public debt and ways of government in Albania**

At the beginning of the decade of the 90-s of last century, Albania began a political, economic and social transformation, with the ultimate goal of the country's integration into international markets with a particular emphasis on joining the European Union. All these remarkable positive revolutions were simultaneously accompanied with a steady increase of budget deficits and public debt levels in years, which is shown in the below graph no.1. Despite the Albanian government efforts tokeep the public debt level at round 60 % of GDP in line with the macroeconomic situation in the country which has not been always very promising, public debt level has recently reached the level of 71.8% of GDP (2015), making it the most critical indicator which constitute serious threat for public finance sustainability in the country nowadays. It should be also stressed the fact that this alarming level of public debt is also a result of the changes made to the budget organic law during 2012, to take out the maximum level of 60% of GDP.

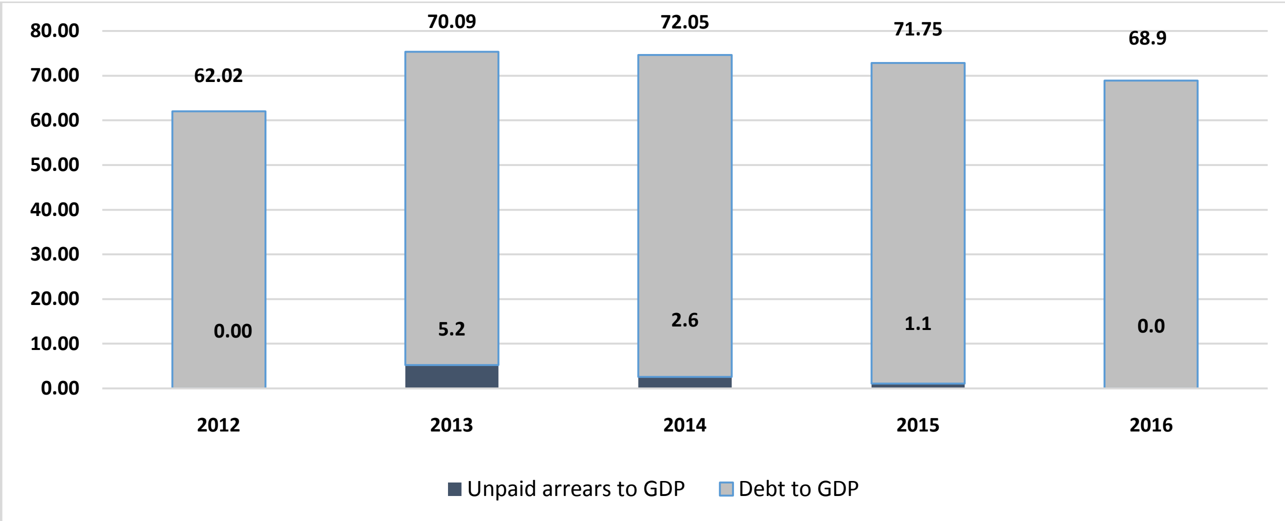
**Graph no.1** Level of budget deficits and public debt in years in Albania




*Data Source: Ministry of Albania, 2015*

As per Domar (1944) or IMF (2003) analysis, public debt must be used to finance capital projects because debt will be served nor by new debts issuing nor by higher taxes, exploiting it in the most efficient way. However the use of public debt is somehow dictated by the macroeconomic situation in the country along with the projects aimed to be achieved from the government which are clearly stated in its political program. Thus the structure of public expenditures and the tax policies constitute political-institutional variables that deliver clear messages of the government political program. In this context the Albanian government decisions to finance projects with high impact to the electorate during years increased in a significant way budget deficit and public debt, especially during the years of financing strategic investments such as the road Durres-Kukes, Elbasan road, and/or other projects related to infrastructure. As theory explaines, general election held in 2001, 2005, 2009, and 2013, coincide also with the years of high level of spending while the growth of public debt level is reflected directly in the following year or not at all, by increasing this way the level of hidden debt in the form of unpaid arrears to private sector that during 2013-2015 reached the worrying level of 5% of GDP, as shown in the graph no.2

**Graph no.2:** Level of hidden public debt in Albania




*Data Source: Ministry of Albania, 2015*

The levels of hidden debt in the form of unpaid arrears would had remained unveiled if IMF and World Bank would not have set theircleareanceasa prerequisitein their 2014's extended arrangement for Albania, beside the public transparency of hidden debt which was convenient even for the new government because a new opposed political partywon the general elections in 2013. As can be noted even from the graph the level of this hidden debt will be nil during 2016, because pursuant to the terms of the loan, the government of Albania drafted a srategy of the arrears repayment toward business and individuals, a process which is serving as an incentive to improve the business climate in the country, but also as compensation for the reduced level of public investments realized during this period. (MoF, 2015).

On the other hand consulting all Albanian governments documents and their political programs individuals can find no relevant information related to the level of debt per capita that are going to pay in the future, which is increasing steadily from the level of 37.980 ALL per capita in 1996 to 376. 185 ALL in 2015[1].This is mainly a result of the fact that government programs do not provide any data in terms of how their fiscal policies will reduce / improve the level of debt per capita in the future, but the information they disclose in public revolves around taxes that will be imposed in the near future, stressing one more the fact that the government is using "fiscal illusion" concept to conceal from the public their financial decision implications which increase

[1] To be noted that also the GDP per capita is increased from 113.096 ALL in 1996 to 545.633 ALL in 2015

the level of debt, which is nothing more than taxes that citizens will pay tomorrow without making it show off.

While with regard to the relation of governing cabinet size and level of debt, although the size the government size in Albania has lately increased due to bigger coalition parties, but despite this the government has sought after and managed to reduce the level of spending on personnel expenditures not to harm public finances, although the level of the expenditures allocated for the programs that coalition parties are in charge and manage such as agriculture, education has increased steadily.

However despite the problems and challenges that the management of public debt in Albania faces, one of the crucial objectives of all strategic documents in force such as in the "Strategy for Public Financial Management 2014-2020" is reducing the level of public debt to GDP, the clereance of hidden debtsdebtsand transparency to the public and mostly the establishment of legal rules especially during election years by preventing depletion of deficits and budget stock approved in the medium term budgeting framework. Moreover the government is giving clear message to reduce the number of budget changes during the year a process which carry a lot of fluctuations in budget deficit during a financial year and restitution of the upper limit of public debt level, which make a good example of how legal restrictions and fiscal rules can improve the the overall macroeconomic situation in the country, when there is a government goodwill. All these facts are noted also in the satisfasctory performance of the economy which is rated by Mooody's as B1 during 2014 constituing a positive signal for the measures and the reforms that the Albanian government has chosen to implement in the future in terms of economic stability, even though its economy performance is quite low compared with other countries in the region

**V. Concluding Remarks**

Public debt is influenced by politics in various forms and this statement is no longer a novelty to economic theories, but finding ways to avoid its effects is a cause of worldwide concern.On the other hand interventions to mitigate the effect of the political factors toward public debt level are difficult since they require constitutional and legal changes that's a result of a cooperation of all political forces in the country, especially where governments are composed from large coalitions. In order to avoid the problems that are caused by groundless actions undertaken by politicians it is crucial to establish some fiscal rules which are often considered as "ornaments" however their importance are widely accepted. Their implementation is mostly important in developing countries but for sake of effectivensfiscal rules must be transparent and flexible to achieve a fully institutional support related to budgetary and monitoring processes.

The same rule applies in the case of Albania where the re-establishment of the legal constraints in terms of the upper level of the size of the deficit and debt and also to the number of revisions of annual budgets during the year can serve as a good starting point, in line with the country's aspirations to join EU and to achieve economic stability.

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