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Budget Deficit and Public Debt Management in Developing Countries

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Abstract

Most of the studies on budget deficit and investment nexus in developing countries have identified that budget deficit has negative impact on investment and growth. This paper in its scope seeks to dwell on the policy implications of the empirical findings. Thus, it focuses on possible reasons for the empirical findings, practical countermeasures to improve public debt governance and finally, how resistance to effective debt control can be overcome.

Key words: Budget deficit; Investment; Developing countries; Public debt governance; Debt control

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INTRODUCTION

Public debt is the accumulation of deficits resulting from excess of government expenditure over revenue (majorly tax and return on investment). Because all deficits need to be financed by borrowing, consistent deficits over the years have led to accumulation of different forms of borrowing ranging from domestic to external. These accumulated borrowed funds by the government made up the Public debt. According to public finance literature, a rising public debt above the sustainable level, especially when it is calculated as a ratio of gross domestic product (GDP) is dangerous and indicates that bad economic time is at the corner; although, this is expected to be in the long-run.

Most of the developing countries are characterised with high debt profile. For instance, for 14 developing countries[1] selected at random, the average public debt/GDP ratio is approximately 48% and 43% in 2004 and 2010 respectively against the benchmark of 30% for sustainable debt for most of the countries. This condition has limited the rate of development in these countries. To avert such situation, developing economies have been striving hard to regulate the level of their public debt to ensure a sustainable debt position. Also, the developed economies have devoted lots of their resources to ensure that the developing ones get out of debt trap. Many of the developing countries in the past have benefited from debt relief to put their debt in a manageable position that will allow for targeted level of development.

Theoretical Literature have produced diverse arguments regarding the relationship between budget deficit and macroeconomic variables. On one part, the neoclassical view argued that increasing budget deficit will have a negative impact on growth. Thus, they argued for a *crowding-out hypothesis*. On the other part, Ricardian view argued that the form of government finance is irrelevant; consumers internalize the government's budget constraint holding that the timing of any tax change does not affect expenditure of the private sector. Therefore, the theory holds that no matter how government finances its deficits, the level of total demand in the economy remain the same[2].

In search of the relationship between budget deficit and interest rate, empirical evidence remain unclear has different studies concluded on different results. Many

[1] The countries are Argentina, Brazil, Cameroun, Croatia, Egypt, Ghana, Honduras, Iran, Malaysia, Mexico, Nigeria, Pakistan, Turkey, and Yemen. The data used is sourced from Index Mundi.com
[2] See the article "Are Government Bonds Net Wealth" (Barro, 1974) for detailed analysis.

in their studies argued that budget deficit indeed have positive relationship with interest rate and thereby reduces the level of private investment (Borensztein, 1990; Elbadawi, Ndulu & Ndung'u, 1996; Iyoha, 1999; Alesina et al, 2002; Ali & Mshelia, 2007; Adedokun, 2014). While, some studies prioritize some variables other than debt burden in explaining the declining state of investment in less developed countries (see Warner 1992; Perasso 1992; Cohen 1993; Traum & Yang 2010 among others). Between these two arguments, some studies justify why budget deficit will put pressures on interest rate and why it will be of no influence[3].

Giving the position of the above literature, what makes a country "developed" and another "developing" is less in the financial resource availability, but more in the management attitude. Developing countries as the name implies, are characterized with deficiencies in public debt governance, and this calls for practical countermeasures to improve governance. This section of the paper highlights the possible reasons for most of the empirical findings in the literature (the negative impact of budget deficit on investment and growth), practical countermeasures to improve public debt governance, and finally, how resistance to effective debt control can be overcome in developing countries.

1. POSSIBLE REASONS FOR EMPIRICAL FINDINGS

This section discusses the reasons for the negative impact of budget deficit on investment and growth in developing countries. Thus, the following should be noted for good management attitude.

1.1 Excess Reliance on Short-Term Loans

In most of the developing countries, the composition of domestic debt is dominated by short-term instruments as banks, especially central bank being the major holders of government securities. In most cases, funds generated from these securities are used to pursue medium-term projects, long-term projects or even on unproductive purposes a times. This places pressures on government as the maturity date of these debts is too short for government to meet up with.

1.2 Poor Funds Utilization and Shortage of Manpower

This inefficiency lies in the utilization culture of the borrowed funds by the management saddled with such responsibility. Funds that should be used for executing capital projects are used to finance current and past consumption. Most developing countries lack sound debt management as many of the debt management offices are still young and inexperienced to perform efficiently. Also, many of the staffs are employed primarily through recommendation by political office holders. All these in most cases, results in shortage in manpower for proper policy management, thereby impedes the ability of developing countries to pay debts when due.

1.3 Corruption

Corruption as they say has eaten deep into the fabrics of the economies in developing countries. The only major deficiency that encompasses all other deficiencies in public debt governance in developing countries can be linked to "corruption". It is so common that if not for the scope of this paper, it would have been the only thing to discuss. I say – immediately corruption is swept out of developing countries, there will be no more nation referred to as developing. Corruption in a lay man's language is dishonesty or illegal behaviour. Formally, it is defined as the abuse of public office for personal gain. Corruption is as a result of many factors including excessive government regulation, complex laws, provision of goods below market value, insincerity in government, poor civil service remuneration, lack of transparency and accountability, institutional weaknesses, nepotism, and so on. It is in developing countries that contract either for construction or maintenance worth of $1million for example will be awarded $1billion; this same inflated project will be awarded four or five times before final execution; falsehood in the court of law; embezzlement; extortion; bribery and so on. All these reduce investments of any kind and economic growth as it eventually creates higher public debt indicators.

1.4 Overspending and Fiscal Indiscipline

Government in developing countries lavish public funds on issues such as provision of unnecessary allowances and facilities, for political office holders and political appointees like ministers; expenditure on subsidy, and government undue involvement in the production of goods that are not pure public. All these cause deficiencies in public debt governance. Also, problems such as unrealistic, hidden and deferred budgeting affect public debt governance in developing countries.

1.5 Poor Alternative Sources of income

Sources of revenue for most developing countries are inherent in the abundance of natural resources, which in most cases are monoculture. This poses lots of challenges on income generation. Alternative source of revenue like tax which is the main source of revenue in developed economies lacks proper administration in developing economies. This constitutes to increase in public debt.

1.6 Institutional Breakdown

Institutions are supposed to mediate and help in the process of good governance. Institutions within the executive, legislative and judicial arm in developing countries have been afflicted with all sort of problems like corruption, Nepotism, political interference, bad coordination and so on. For instance, a poor citizen that steals $100 will be prosecuted and sent to jail but

[3] World bank justified the influence of financial market (repressed and non-repressed) (1993) and the possibility of acquiring external loan in determining if budget deficit will have anything to do with interest rates.

public looters who steal millions of dollar go without prosecution. This problem has made good financial governance practically impossible within the economy of developing countries.

2. PRACTICAL COUNTERMEASURES TO IMPROVE PUBLIC DEBT GOVERNANCE

2.1 Restructuring of Debt Portfolio

This is necessary to save the public debt condition. The idea is to make long-term instruments such as bonds, to dominate the composition of domestic debt. The strategies on one part, is that the dormant and undeveloped bonds market in most developing countries will be reactivated; on the other part, existing short-term instruments will be restructured by lengthening the maturity date to allow for sustainable debt. In addition to the above, government funding by the central banks should be reduced to the minimum. Without this, there will be an injection of high-powered money into the economy which eventually will lead to inflation and exchange rate instability, this will shrink export and crowds out private sectors from credit facilities which affect investment and contracts output.

2.2 Recruitment Due Process and Effective Capacity Building

I recommend that recruitment into debt management be based on merit. This can be made possible by contracting recruitment exercise to reputable private firms. This will ensure due process in debt management. In addition to this, effective capacity building and training should be well invested on so as to ensure proper service delivery by debt managers, through necessary skills acquisition and adaptation to new technologies and techniques. When "effective trainings" are given to the "right people (who can comprehend the ethics of public debt management)"; definitely, funds will be channelled effectively and return on government projects will be well evaluated, thereby debts can be paid when due.

2.3 Transparency and Accountability

This is a requisite for any form of governance that wants to reduce corruption. Transparency means information accessibility to the public, while accountability means explanation or justification for what has been done or failed to do. The following should be done to improve transparency and accountability–all issues in the government yearly budget should be well articulated; asset declaration by "political office holders" and "public principal officers" both in the beginning and end of every financial year; publicize take home pay of political office holders and political appointees like ministers; budget appraisal at the end of the year by reputable private audit firm; encourage political mobilization groups to express public opinion and monitor government performance. In the pursuit to eradicate corruption, I recommend to developing countries that office holders caught stealing should face capital punishment such as death penalty. This may not be economic and may sound stupid, but one thing I have got to know over time about people in the developing world is that they will prefer not to involve in any act (either positive or negative) if it will not directly improve their utility: all that steal want to enjoy it personally. Trust me; it will protect public funds in developing countries.

2.4 Avoid Unnecessary Spending and Involvement

I advise all developing countries to develop adequate checks for unnecessary spending and lavishness that may result from excess allowance such as money allotted to feeding and wardrobe and unnecessary travelling trip by political office holders and political appointees. Also, unnecessary involvement through investment on goods that are not pure public should be avoided through effective public-private partnership management exercise.

2.5 Improve Alternative Sources of Revenue

Governments of developing countries should endeavour to increase their sources of revenue, especially through taxes. Public awareness programme on taxation, reformation of tax policies and administration should be enhanced. I recommend that government should reduce and discourage informal market sector and face out underground economy through the introduction of cashless economy. This will reduce tax evasion occurrence. Also, practices like deregulation and privatisation will help developing countries to generate more incomes and reduce growth in public debt.

2.6 Institutional Build-Up

It is in developing country that a judge will be relieved of his duty when he or she ruled against the wish of the executive. Until judiciary sees itself independent of executive threat, developing countries cannot enjoy good governance. Therefore, I recommend that judiciary be granted total autonomy including appointments and disappointments. In the same vein, officials' appointment into anti-corruption agencies should not be the duty of the executives – you cannot bite the hands that feed you without facing the consequence. I recommend that anti-corruption agencies be a subsidiary of an independent judiciary if they are expected to perform to full capacity.

3. HOW RESISTANCE TO EFFECTIVE DEBT CONTROL CAN BE OVERCOME

Effective debt control may encounter resistance from the general public. Resistance often occur as a result of uncertainty in debt control policy on the part of the public as they doubt the benefit from such policy. To avoid or overcome resistance to policy, I recommend the following.

3.1 Education and Enlightenment

The first important thing to do to avoid resistance to policy is education and enlightenment. This makes the policy clearer to the public in terms of the benefits that go with the change and makes them see reasons to support the change in policy. So when the public know what they stand to gain, they refrain from resisting the debt control policy.

3.2 Transparency

It is imperative the public know practically everything both the advantages and disadvantages of the policy. It is also important for the government to expose all hidden facts surrounding any debt control proposal to the public. This is because when the public discover any hidden agenda in policy, they will lose their trust and resist such policy.

3.3 Precedent

Government should be mindful of what she does today because she will surely be judged by that in the future. When the public do not trust the government of anything she says anymore, they will resist whatever such government says even when it will benefit them. For example, the government of Nigeria in 2005 promised during the administration of president Obasanjo that the proceeds from debt relief will be used to develop infrastructure, but till today no one can attach any infrastructural development to proceeds from debt relief. Again, the present administration of President Jonathan claimed the proceeds from fuel subsidy removal will be used for infrastructural development, till date nothing can show for it. This definitely will stand against such government in the future, regardless who the president is.

3.4 Public Involvement

When government involve the public in both designing and implementation of policy, the public will not feel cheated as they stand as a party in the process. This is because it is hard if not impossible to oppose what you are a party to. Thus, the government stand a chance to avoid and overcome the possibility of resisting debt control policy by the public.

3.5 Public Support

When there is debt control policy, definitely some people have to pay for this. Therefore, because some people if not majority will be worse off in the short-term, there is the need for provision of palliatives to cushion the negative short-term effects of such policy. One important thing here is that the palliatives should have been provided before policy implementation if resistance is to be avoided. A practical example of this is seen in Nigeria where government's failure to provide palliatives before fuel subsidy removal result in nation-wide strike. As a friend will always say, it is better you place a hip of cloth on a bare-headed person before placing a hot pot on him, rather than pouring water on his head when the head is burnt as a result of the hot pot.

3.6 Negotiation

If all the five modalities above are religiously carried out, there will not be much need for negotiation. But in the presence of resistance still, the government can call for negotiation with leaders of all aggrieved unions. This may result to shifting of grounds by the government and the public. Both parties at this point sacrifice something to allow for peace. Who gets the larger share here depends on how good each party can negotiate. But, what if negotiation fails? I recommend more of negotiations. This is because other weapons like Manipulation and Coercion, which is common in developing countries will produce more resistance and may eventually lead to violence.

CONCLUSION

This paper identifies that public debt, due to continuous occurrence of budget deficits in developing countries has been a serious challenge both in the past and in the recent times on investment and economic growth. However, the opinion of the paper is that, if debt management could be properly done, developing countries can experience economic growth. Thus, the paper highlights the possible reasons for most of the empirical findings in the literature (the negative impact of budget deficit on investment and growth), practical countermeasures to improve public debt governance, and finally, how resistance to effective debt control can be overcome in developing countries.

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