

# [Public finance](https://assignbuster.com/public-finance/)

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Due Budget deficit, Public Debt and the Risks of Voluminous Debt Quite simply, a government running under a budget deficit operates/expends in excess of its total revenue collections. As a result, the extra expenditures are financed by the government borrowings through the issuance of government debt, either internally or to external investors. Public debt, thus, sums up the overall stock of outstanding IOUs issued by the government in the past and not yet serviced (Diamond 1126). Intuitively, public debt equals the cumulative net borrowing by the government from the public over time, and that the annual budget deficit accruals are just but the current period additions (year, quarter, month, etc.) to the total outstanding public debt. It is an obvious fact that the current disorder of public finances of industrial countries, particularly the United States and those in the Euro-zone, is a dilemma with a strength-supping dimension that only compares to the aftermath of WWII. Notwithstanding the austerity measures, economic stabilization that resulted into fairly rapid reduction of debt/GDP ratios after WWII seems rather unlikely. With the aging populations significantly adding to the fiscal burden of the high public debt induced by the 1930s Great Recession and exacerbated by the subsequent crises, the United States and Euro-countries are staring at a challenge that will not disappear any soon. The consequential impact of public debt build ups can well be understood from the perspective of economic sovereign debt crises as well as the subsequent exit strategies sought after to salvage a nation(s) from complete collapse as was the case with the defunct USSR. The bulging government debt has been a remarkable trend over the past decades, possibly due to the ever expanding size of governments. For the developed world in particular, the general growth of the government expenditure was more of a 20th century phenomenon. The average size of governments for thirteen industrial countries increased from approximately one eighth of their GDP in 1913 to almost half in the early 1990s (Tanzi and Schuknecht 165). Concurrently, the average public debt-to-GDP ratio shot up considerably for both big and small governments at the end of the period and beyond. Besides the size of governments, economic and financial crises have also had their fair share of government debt build-ups. The Great depression of 1930s, the post-World War II financial crises and the recent 2008-2009 financial crisis all left signs of considerable strains on public debt thereby throwing managerial aspects of public finances of many countries into disarray. From a marginal 0. 6 percent of the GDP in 2007, the euro area governments’ deficit ratio not only rose to a new level high touching on the 6. 5 percentage mark in 2010/2011 after the recent financial meltdown, but has also left a trail of miseries that still threaten to turn back the tide of the global economic gains made this far. Though under control, the euro crisis has eroded fiscal sustainability in the euro-zone to dangerous levels that the effects would certainly linger on both in the medium and longer term. Even though the national debt is created as a counter-cyclical measure “ in spite of the possible monetary policy remedies that ensures the rebalancing of interest rates to its lowest feasible levels” (Modigliani 753), public debt increases is generally not a costless undertaking for future generations despite the short-term beneficial effects to the current generation. Ceteris paribus, there is no doubt that the current dwindling economic prospect of the United States is a consequential aftershock of the many years of increases in the public debt-to-GDP ratio. Noteworthy, theoretical literature points to a negative relationship between public debt and economic growth with possible deleterious effects on the private savings. Accumulated national debt is a burden that comes in the form of direct crowding-out effect that consequently reduces the flow of income from private capital (Diamond 1133-5). In his theory of “ debt overhang”, Krugman (253-5) argues that public debt accumulations only promote investments up to a certain threshold beyond which a debt overhang activates negative pressure on investors’ readiness to provide capital, a scenario that automatically dampens any potential gains in output growth. Through the impact of taxable payments needed to finance interest accruals on the public debt, the surcharges ultimately diminish the available lifetime consumption of the current generation taxpayers, over and above their savings, and thus the available capital stock. The genesis of the 2008/2009 financial meltdown and the Greek’s debt crisis culminating into a Euro crisis are clear pointers that the fiscal and financial dynamics of many countries, particular the industrial world, carry characteristics of crisis situations which demand tougher policy responses. Notably, the average debt-to-GDP ratios of many euro-countries had already crushed the minimum borrowing threshold and that the detrimental impact on their entire GDP growth momentum in the form of a crisis was just but a formality in waiting. The evidence may as well constitute warning signals for the United States to restructure its economic policies in favor of swift implementation of ambitious strategies for proper debt reduction. The fear of fiscal consolidation measures due to their unpopular nature with the voters only serves to undermine growth prospects in the long run with additional burden on fiscal sustainability. Work cited Diamond, Peter A. “ National Debt in a Neoclassical Growth Model.” American Economic Review 55. 5 (1965): 1126-1150. Print. Krugman, Paul. “ Financing vs. Forgiving a Debt Overhang: Some Analytical Notes.” Journal of Development Economics 29 (1988): 253-268. Print. Modigliani, Franco. “ Long-Run Implications of Alternative Fiscal Policies and the Burden of the National Debt.” Economic Journal, 71. 284 (1961): 730-755. Print. Tanzi, Vito and Schuknecht, Ludger. “ Reconsidering the Fiscal Role of Government: The International Perspective.” The American Economic Review 87. 2 (1997): 164–68. 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