

CAUSES OF THE GROWTH OF PUBLIC DEBT AND BUDGET DEFICIT IN ALBANIA: REPORT BASED ON RAPORT RULE OF MAASTRICHT (60/3 OF GNP) - RECOMMENDATIONS FOR REDUCING THESE PARAMETERS

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Abstract

After the 2008 financial crisis in the U.S. and its transformation in the global economic crisis, the reduction of public debt and budget deficit have been key words in the design of public budget in each country. In this article, we analyze the causes of the growth of public debt over the limit (40-50% of GNP) of Albania as a developing country. However, two major causes of increasing public debt and budget deficit are (a) the current economic crisis and (b) the reduction of tax under the flat tax. The public debt and the budget deficit of Albania are increased over the limit defined in the rule report 60/30 Maastricht Treaty, mainly due to the deepening of the crisis and inefficiencies of the flat tax in public income collection.

To argue that the economic crisis and tax reduction policies have led to increased public debt and budget deficit, we analyzed data on the budget deficit, public debt, remittances etc., for the period of 2000-2011. Another purpose of this paper is to compare the region with Albania, such as Bosnia-Herzegovina, Greece, Kosovo, Croatia, Montenegro, Macedonia, Romania, Serbia and Turkey.

Keywords: Budget deficit, public debt, remittances, taxes, expenses, income, economic crisis

Introduction

What is budget deficit and public debt?

Economic agents (individual, entity and the government) have no limit to the needs for goods and services and limited opportunities for cash. Based on this fact, governments with their budgets do not cover (face) expenses with the incomes they collect. Therefore, negative difference of spending with incomes during a fiscal year is known as total budget deficit.

Total budget deficit consists of two components: (a) primary deficit and (b) interest payments. Primary deficit (or surplus) represents all exits (expense) of the government, excepting interest payments, minus all government incomes. Primary deficit is also known as deficit without interest (Blejer & Cheasty, 1991).

In order to equalize spending with incomes, the governments usually borrow. Public debt at a given time is the sum of all past budget deficits. In terms of economists, public debt is a "stock variable" (measured at a point in time), while the surplus and deficit are "derived variables" (measured over a period of time) (Rosen, 2003:511-512). Therefore, the net stock (state) of the outstanding government debt is known as the national debt or public debt (Dornbusch & Fischer, 2000:539).

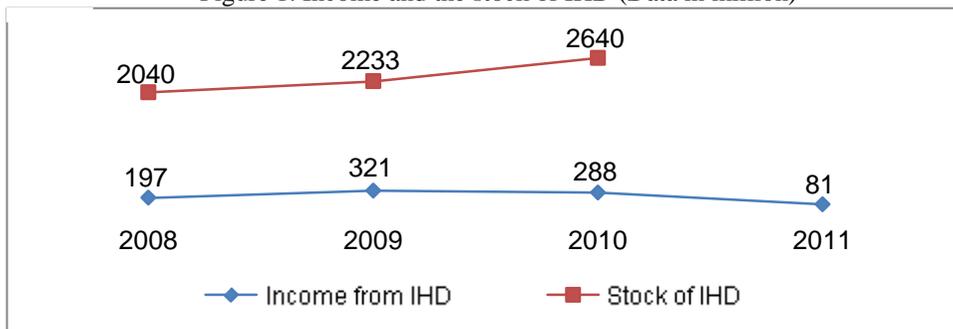
The economic crisis in Albania

The shock of "Stock Exchange" and financial markets during the fourth quarter of 2008 reminded everyone once again of the biggest crisis in the history of modern capitalism, from 1929-1932 in the U.S. (Civici, 2012: 109). This crisis is affecting to a great extent the developing countries of Central and Eastern Europe, which initially were expected to be unaffected and as such, there is no exception for Albania (Currie, 2009:19-16). The crisis in Albania has been imposed mainly by its neighbors such as Greece and Italy. This appeared with reduction in remittances from these countries, which has brought unemployed Albanian immigrants and their income scale down as a result of the crisis.

Continued global economic crisis in Albania has led to some businesses failures, while others reduce their production in the market. According to the Statistical Institute, the number of entities with the status of limited liability companies has been reduced from 2008 onwards. Specifically in 2008, we have 2489 businesses, while in 2009, only 2225, or 264 businesses were left. From 2009 to 2010, the increase is very small from 2225 to 2255 or 30 more businesses. So, the economic crisis has reduced the number of businesses due to the closure of their activity, and has brought reduction in income to other businesses that are in the market, which is the fact that enables less revenue in the public budget.

The economic crisis in Albania has also reduced foreign direct investment. According to the "Report on foreign investment in Albania in 2011", which was published on May 2012 by UNDP Albania and UNCDAT United Nations, income from foreign direct investment tend to decrease while stock tend to increase (May, 2012:17). Refer to Figure 1 graphic interpretation.

Figure 1. Income and the stock of IHD (Data in million)



Source: Bank of Albania

The problem of unsold stock is evident in domestic investment too. For example, in the construction industry, Builders Association reported 12 thousand unsold apartments nationwide. Besides stagnation that has caused the decrease on the demand and lack of credit in the construction sector, the government’s liability against builders that reaches 100 million, has been one of the main obstacles that blocked the work in this sector. High stock of unsold buildings and economic crisis does not provide much incentive for new investment in this sector (<http://news.albania.com>, Dated 13 February 2013). Growing stock not only from FDI (foreign direct investment), but also from domestic investors, theoretically comes from low taxes. In years '30, it was argued that the application of lower taxes has theoretically and practically encouraged several businesses to produce and to earn more. In economics term, manufacturing entities overestimate demand. Because of this overproduction, the quantity people want to buy is not equal to the quantity produced. So, we have unplanned investment (Dornbusch & Fischer, 2000:69). Nowadays, another reason that explains the growing stock is technological development which provides more production on the market.

Low tax policy in Albania

After the year 2005, lower taxes policy was applied in order to attract foreign investment in Albania. The first was in 2006 "Albania 1 euro" (Mr.Belortaja 2006) and the second was a "flat tax rate of 10%". Flat tax rate of 10% is among the lowest in Europe. Even if we talk about the reduction of tax policy, Albania has not performed well compared to most countries in the

region. Two taxes which were affected by the application of the flat tax rate are PT (profit tax) and PIT (personal income tax). However, these taxes are important to the public budget.

The Table 1 shows income from PT and PIT for the period 2005-2010. This period is divided into two sub-periods: 2005-2007, whereby a scalable progressive tax on personal income and proportional tax at 20% on the income of companies has been applied in our tax system, and the second period from 2008 to 2010, by which the flat tax rate of 10% on personal income and income from commercial companies is been applied in the system.

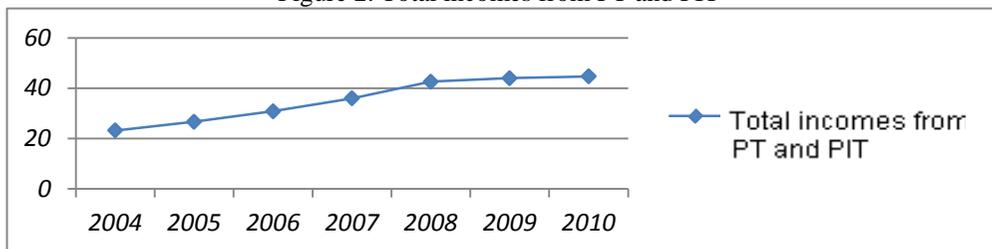
Table 1. Incomes from PT, PIT (data in billions)

<i>Years</i>	<i>PT</i>	<i>PIT</i>	<i>Totally</i>	<i>Increment %</i>
(1)	(2)	(3)	(3)	(4)
2004	16.308	6.852	23.160	
2005	19.237	7.402	26.639	115%
2006	22.258	8.580	30.838	116%
2007	21.077	14.850	35.927	117%
2008	18.108	24.498	42.606	119%
2009	17.149	26.820	43.969	103%
2010	17.606	27.058	44.664	102%

Source: Data for PT and PIT are taken from INSTAT.

As we look at the data in columns 3 and 4 of Table 1 and the graph in Figure 2, the increase in income for the period 2005-2007 is very noticeable. Therefore, the total income curve has a positive slope. At this period, proportional tax on the income of companies and scalable progressive tax on personal income was applied.

Figure 2. Total incomes from PT and PIT



Another situation is presented for the period 2008-2010. Incomes from PT and PIT have increased but the slope of the curve is not the same as the period from 2005-2007 (has not followed the trend of previous years). So, after applying the flat tax, incomes tend to increase small from year to year.

Literature Review

History of the labor supply side as theory of low taxes

Public debt in the U.S.A. is increasing almost every year in the past 50 years (Dornbusch & Fischer, 2000:533). "Fever" of large deficits included the U.S.A. in the early 80 's. During this period, the U.S.A. was facing an economic recession and in 1975, the administration proposed a law to cut taxes in order to encourage the economic development of the U.S.A (Dornbusch & Fischer, 2000:537). This fiscal policy is based on "the history of the labor supply side." This story was made famous by a diagram proposed by Arthur Laffer, a former economics professor (Roberts 1980 & Bartley 1992). Thus, economists of the labour supply side support tax cuts, arguing that their reduction would help in increasing production. According to them, tax cuts encourage individuals and entities to work more because their income has increased. (Dornbusch & Fischer, 2000:540). Therefore incomes to the public budget will rise. Increased incomes to the public budget reduce the budget deficit and this reduction in budget deficit assists in keeping public debt under control.

In Albania, "the history of the labor supply side" as theory of lower taxes, has not led to increased incomes in the public budget, which brings about reduction of the budget deficit and public debt. Thereby, this conclusion in the report of the IMF (International Monetary Fund) for 2011 is written: "For the flat tax which is currently 10 percent, we recommend tax increase, even with few more percent, as it may bring significant income in the budget and also brings real wage decline in public and private sector. According IMF, results have not been the right ones in these three years. Hence, in these conditions, the government should review these taxes (www.albanwes.al).

Reduction of incomes from PT is explained also by the non increasing number of businesses as a result of the flat tax application and informality in the economy which is as a result of inefficiency and corruption in tax administration. To argue the level of corruption, we brought attention to a report published by the non-governmental organization for "Transparency International" in 2012, where Albania has 33 points in Corruption Perception Index of 100 possible points and has lost 18 points in ranking, being the 113th from 95th place that held a year ago (Rabeta, 2012 & newspaper "Panorama" Thursday 6 December 2012).

Factors that leads to huge deficits

Dornbusch and Fischer (2000) in their book "Macroeconomics" presented the two main factors that have led to large deficits. These factors are (a) increased interest for received debt and (b) political deadlock. The second factor is related to the higher taxes and lower spending. Politicians

are not willing to assume such policies and deficits. While the debt increase and this leads to increased interest payments added to the deficit.

The current crisis was grave after that of 30's has the awareness of the political class to raise taxes and cut spending. Almost all governments and nations of the world are developing rapidly; thus, "special anti-crisis strategy" are developing alternative platform to backup scenarios in response to situations that may come, and are also creating "special ministerial units" to follow "day by day" situation, which are exceeding on a second plan political controversy and conflict "majority-minority" in order to dedicate maximally economic and financial issues in their countries and regions (Civici, 2012: 1330).

What is the ratio rule 60/3 of the Maastricht Treaty?

Rule report 60/3 as a fiscal convergence criteria, determined in the treaty of Maastricht (in the 90s) means that the economies of the European Union, aspiring to become part of the euro common currency zone should have the budget deficit (annual parameter) of not more than 3% of Gross National Product (GNP) and the public debt of not more than 60% of GNP (Kukeli, 2012). Scientific meanings of these two economic parameters is based on the fact that these levels, which are that of the budget deficit and public debt are such that do not allow further growth of debt "cumulative" and technically, the debt is settled. Two further qualifications which are necessary to make this rule a more understandable fiscal convergence is that: (a) nominal annual rate of economic growth should be not less than 5% and (b) inflation should be within the parameters of the country's Central Bank which implies a moderate inflation (Kukeli, 2012).

Methodology and Hypotheses

To analyze public debt in Albania over the desirable limits of 40-50% of GNP and overcoming the ratio rule 60/3 of Maastricht treaty, data on budget deficit and public debt in the period 2000-2011 in Albania and other countries of the region: Bosnia-Herzegovina, Croatia, Montenegro, Macedonia, Romania, Serbia and Turkey were analyzed. Data obtained from budget deficit, public debt and economic growth in Albania were taken by INSTAT (Institute of Statistics), while for the other countries of the region, data were taken from the IMF (International Monetary Fund). However, the discussion is based on the methodology of time series (Mayo, 2011) and comparing of data between the countries of the other region and Albania regarding desirable limits of 40-50% of GNP, as well as the ratio rule 60/3 of Maastricht treaty.

In this paper, we took the following assumptions:

H1: Has regional economic crisis affected the growth of the budget deficit above 3% of GNP and consequently the growth of public debt above the desired limits 40-50% of GNP ?

H2: How did the introduction of flat tax increase budget deficit over 3% of GNP and consequently the growth of the public debt over the desired limits 40-50% of GNP?

H3: Does the theory of "the history of labor supply" reduce the budget deficit and public debt in the desirable limits?

Results and Discussion

Why should not rely on the ratio rule 60/3 of Maastricht treaty related GNP?

Although there is no specific number on which analysts agree on the public debt, the rough consensus on this issue is that developing countries comparable with Albania (for example, Eastern European countries) should try to maintain a debt level below 50% of GNP, possibly at the level 40%. The ability of the economies of these countries to deal with economic shocks and strong fiscal space to accommodate their needs in case of shocks is limited, so it was recommended to stay away from high levels of debt. 60% level, although adopted earlier in our legislation of public finances, does not necessarily reflect an optimum level, but an application of a recommended limit by the treaty of Maastricht in 1991 for the European Union (Demiraj 2013). To discuss the budget deficit and public debt, we will refer to the data in Table 2.

Table 2. Budget deficit, public debt and economic growth in Albania for the period (2000-2011) in percentage

Albania	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Budget deficit	7.67	6.93	6.09	4.89	5.07	3.46	3.33	3.53	5.53	6.95	3.21	
Public debt	72.41	67.38	65.46	60.71	57.72	58.23	56.68	53.85	55.16	59.51	60.55	61.87
Economic growth	7	8	4	6	6	6	5	6	8	3	2.8	

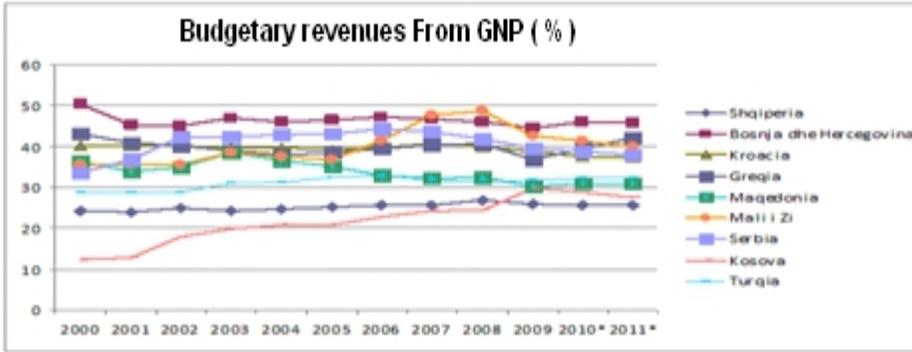
Source: The data for economic growth and budget deficit were obtained by the Bank (for 2010 are preliminary data), while the data on public debt were obtained from the FMN.

Based on the data of Table 2, as well as the standard (limit) decided above, the budget deficit should not be more than 50% and possibly closer to 40% of GNP. Thus, we notice that Albania (a) have had a budget deficit above 3% of GNP, a fact that contradicts the ratio rule 60/3 of the Maastricht treaty and (b) the impact of economic crisis after 2008 has reduced economic growth below 5% GNP criteria which keep debt under control.

Public income in Albania and comparison with regional countries

To argue that the public budget incomes in Albania have been among the lowest in the region (Bosnia-Herzegovina, Kosovo, Croatia, Greece, Macedonia, Montenegro, Serbia, Kosovo and Turkey), we will refer to Figure 3.

Figure 3. Budget incomes to GDP



Source: IMF, Comments and Analysis ODA (open.data.al)

As we look at the graphical analysis in Figure 3, Albania has the lowest incomes of GNP in the region. While ranked first, Bosnia-Herzegovina (46%) followed which was followed by Montenegro (43%), Serbia (39.5%), Croatia (38.7%), Greece (36.9%), Turkey (39.7%), Macedonia (30.3%) and Kosovo (29.7%). By analyzing the budget incomes during the years, we noticed that the country with the largest reduction in incomes during the last decade is Greece, while the country with the largest increase in incomes is Kosovo (www.getbookee.org).

Public debt in Albania compared with the region

As we see from the data in Table 3 and graphic interpretation in Figure 4, the stock debt of Albania is the highest in the region after Greece (115.2%). While, after Albania (59.9%) was ranked, it was followed by Turkey (45.5%), Montenegro (38.25%), Serbia (35.6%), Croatia (35.41%), Bosnia-Herzegovina (35.37%) and Macedonia (23:48%).

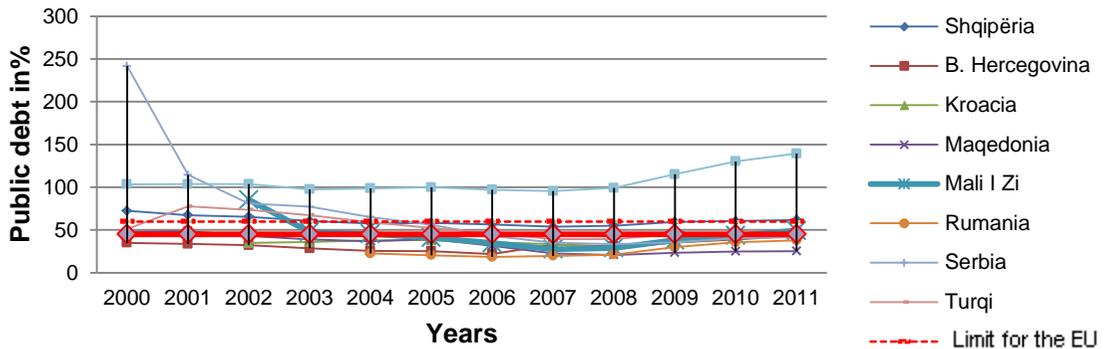
Table 3. Public debt of the countries of the region in percentage (2000-2011)

Places/Years	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Albania	72.41	67.38	65.46	60.71	57.72	58.23	56.68	53.85	55.16	59.51	60.55	61.87
B. Herzegovina	34.98	33.69	32.29	28.45	25.54	25.33	21.81	32.9	30.83	35.37	39.07	43.03
Croatia			34.88	35.85	37.86	38.39	35.8	33.25	29.27	35.41	39.99	42.57
Macedonia	47.92	48.8	42.92	38.96	36.62	39.55	31.52	22.75	20.82	23.48	24.95	25.38
Montenegro			85.51	47.75	45.44	40.91	34.76	27.51	29	38.25	43.52	49.38
Romania					22.46	20.42	18.38	19.79	21.33	29.91	35.49	37.74
Serbia	241.65	114.49	81.21	77.28	65.2	56.29	43.03	35.24	33.42	35.58	40.5	41.61
Turkey	51.31	77.56	73.67	67.35	59.24	52.31	46.08	39.44	39.48	45.5	43.38	42.39
Greece	103.44	103.72	103.72	97.45	98.57	99.99	97.12	95.56	99.19	115.16	130.24	139.35

Source: ODA (open.data.al)

Analyzing over the years, we saw that the country with the most drastic reduction of public debt over the last decade is Serbia, while the country with the largest increase is Greece. In the case of Albania, the stock debt of GDP has been almost constant, but given the annual GNP growth during this decade, then it can be said that the debt has increased by the same rate.

Figure 4. Public debt of Albania and the countries in the region



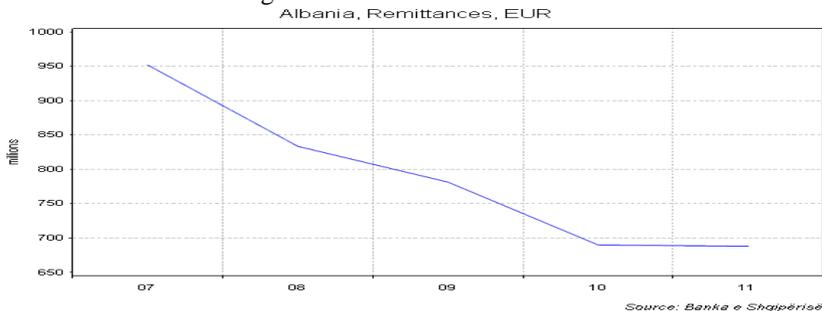
Source: FMN assessments, reviews and analysis ODA (open.data.al.)

Reasons (causes) of public debt growth in Albania

The decline in remittances

Remittances have been one of the major "engines" of economic growth in Albania. Albanian economy has had a high dependence on remittances from migrants abroad. In some polls, it has been shown that a quarter of the existence of family units in Albania depend on remittances, which is one of the highest rates in the world, while it is estimated that the country has about a million immigrants working abroad, mainly in Greece and Italy. The economic crisis in Greece and Italy is showing its effects on remittances, which have been declining since 2007. The following data from the Bank of Albania shows the continuous decline of remittances. Hence, this is a bad indicator for the Albanian economy as remittances are expected to continue the trend of decline in the coming years.

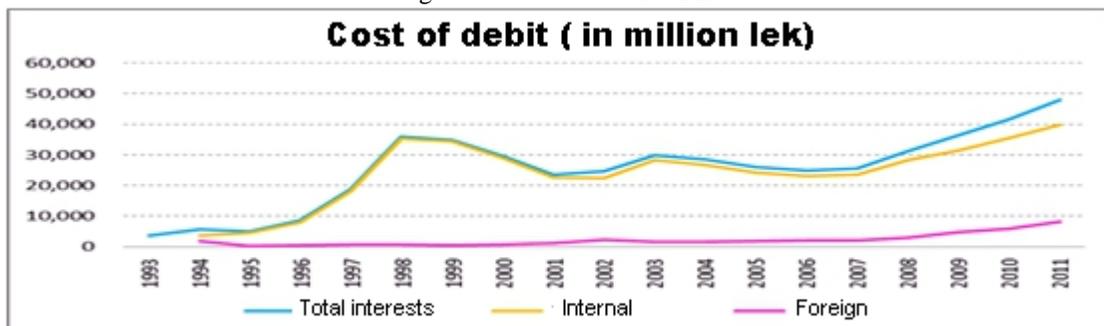
Figure 5. Remittances in Albania



Increasing debt interest

The amount of interest paid depends on the debt stock and interest rate. As we see from the graph in Figure 4, since 1996, the cost of debt grew rapidly and in 1998, it was 10 times higher, than in 1993. In 2001 and 2002, it reached the lowest level for 2000, while since 2008, the amount of interest paid does not have a small impact on the whole of the expenses made by the budget state.

Figure 6. Cost of debt in million



Source: Ministry of Finance. The data from 1993 to 2010 are factual data. Data for 2011 are estimates obtained from the consolidated budget for this year. Processing and comments ODA (open.data.al.).

Conclusion

Comparing Albania with other countries in the region, based on the analysis of the above data on the budget deficit and public debt, we conclude that:

1. Regional economic crisis and beyond, has increased the budget deficit and public debt in Albania over the desired standard (40-50%), but also exceeded the ratio rule 60/3 of the Maastricht treaty. This increase is confirmed by the fact that, after 2008 and after the flat tax of 10% was being applied, incomes were not increasing with the same trend as of previous years. The economic crisis also has brought about reduction on remittances, mainly from Greece and Italy. The decrease in incomes was also noticed in FDI. The decrease in income of individuals and entities, as well as remittances decline, has led to increased stock (unplanned investments) from foreign investment, as well as the internal ones.

2. The current crisis cannot be compared with the crisis of years '30. Our conclusion consists of the fact that the "theory of the history of labor supply" or lower taxes, is not efficient and does not help Albania resolve crisis. Therefore, the above analysis only confirmed that the application of the flat tax on income from PT and PIT in Albania does not follow the trend of previous years (after 2008) and consequently results to an increased budget deficit and public debt.

Recommendations

To reduce public debt in the desirable standard (40-50% of GNP), we therefore recommend the theory of "political deadlock". This theory is connected with the fact of higher taxes and lower spending. The political class should undertake such reforms to reduce public debt. Following the example of some of the world's governments, "ministerial special unit" should be created to undertake reforms to increase taxes and reduce spending.

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