

Avoiding the Debt Trap:

Public Finances in Crisis
and Recovery

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CREDITS

Centre for European Studies
Design: RARO S.L.
Printed in Brussels by Drukkerij Jo Vandenbulcke
Brussels
Centre for European Studies
Rue du Commerce 10
Brussels, BE – 1000

The Centre for European Studies (CES) is the official think-tank of the European People's Party (EPP) dedicated to the promotion of Christian democrat, conservative and like-minded political values.
For more information please visit:

www.thinkingeurope.eu

This publication receives funding from the European Parliament.

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Executive Summary

As a consequence of the most severe economic crisis in post-war European history, public debt is bound to reach record highs in many EU Member States. This can be explained and partly excused by three factors: (a) lower tax revenues and higher welfare expenditures are an inevitable but stabilising consequence of a recession; (b) rescue packages to avert the collapse of the financial sector have in most cases been necessary and effective; and (c) additional fiscal stimulus measures could at least in part be justified as further stabilisers, especially of labour markets.

The danger of severe fiscal deterioration is not, however, the result only of the present crisis. The prospect of ending up in a serious debt trap has more profound causes including both pre-crisis omissions and post-crisis challenges: (a) Many EU Member States had already reached unsustainable levels of debt before the crisis; they failed to balance their budgets during good times in order to be prepared for bad times. (b) For most European governments, the advent of bad times, bringing with them explosive increases in fiscal obligations due to strains on social security systems, has long been a predictable consequence of demographic change. The net present cost of this lasting debt burden is many times larger than that of the present, and passing, recession (see part 2).

As Nobel Laureate James Buchanan (2000, 447) put it, debt-financed public consumption amounts to 'chopping up the apple trees for firewood'. Future generations are left not only without an orchard but also with the obligation to pay back the debt from previous spending sprees, and to pay

into a system of social security that entails higher contributions for lower benefits. On the basis of conservative values the implicit expropriation of future generations has to be clearly identified and avoided as being socially unjust (see part 3).

Even though governments and citizens/voters deplore the injustice of living at the expense of future generations, it is a most challenging task to ask them (to ask ourselves) to take the necessary steps. Since defaulting on or inflating away public debt is not a responsible option, a long-term strategy for escaping the debt trap is needed. Such a strategy involves short-term pain to avoid long-term economic sclerosis. I discuss five *prima facie* reasonable options for a return to fiscal responsibility (see part 4):

(1) *Higher taxes* might still increase public revenue. However, it can be shown that many EU governments are already quite close to over-taxing their citizens, which means that higher taxes could lead to lower growth and thus even higher debt-to-GDP ratios in the longer run.

(2) *Lower public expenditures* would more directly and reliably reduce the fiscal burden. A reallocation of public spending from 'consumption' (e.g., social welfare, defence, redistribution) to 'investment' (e.g., education, research, basic infrastructure) could have the most beneficial consequences for future generations.

(3) *Economic growth* is the best way to cope with constant absolute levels of public debt. If, by letting competitive market forces create innovation and growth, GDP can be raised to higher levels, the debt trap can fairly comfortably be avoided. Growth-enhancing structural

reforms such as the deregulation of labour markets or a further opening of European markets for services might contribute to more sustainable economic growth and to overall reduced public deficits.

(4) *Reforms of social security systems* are urgently needed in most EU countries in order to address the tremendous 'implicit' future public debt due to the demographic shock. This part of the future fiscal burden will not be offset even by above-normal economic growth. Hence strategies for health care and pension reform should be given priority. Increasing the effective retirement age, for example, has a two-fold positive effect on the public balance sheet by prolonging revenues (income taxes and social security contributions) and delaying expenditures.

(5) *Credible political commitments* are needed in order to avoid short-term political temptations to chop down the apple trees for vote-winning firewood. All the above-mentioned recommendations might well be asking too much of ordinary politics. There are, however, ways to escape the debt trap in a sustainable way. Constitutional amendments such as the one recently passed in Germany (a qualified balanced-budget rule) might be helpful to bind politicians to principles that ensure sustainable fiscal responsibility.

1 Introduction

The practice of contracting debt will almost infallibly be abused in every government. It would scarcely be more imprudent to give a prodigal son a credit in every banker's shop in London, than to empower a statesman to draw bills, in this manner upon posterity.

DAVID HUME (1754/1987, 352)

David Hume's warning has not lost its biting relevance even 250 years later. The 'practice of contracting debt' has become common in the modern world—both amongst prodigal sons or daughters and amongst their parents. With the advent of the Keynesian revolution during the 1960s, many economists and, even more so, most politicians even regarded 'drawing bills upon posterity' or deficit spending as a most prudent thing to do. This approach was widely rejected by economists during the 1970s—at a time when it was most widely cherished by politicians (Buchanan 2000, 365ff.). Until very recently, deficit spending had almost completely lost its adherents in economic theory and, at least rhetorically, in political statements of intent.

The present economic crisis, the most severe in post-war European history, has changed the picture once more. Keynesianism is suddenly back—reluctantly in economics and quite wholeheartedly in politics. As a consequence, public debt is bound to explode not only in the US but also in many EU Member States, including states within the Eurozone. Most observers are expecting public debt to increase dramatically this year, 2009, and to continue to do so even after the recession has come to an end.

The danger of ending in a debt trap, severe fiscal deterioration, has two main causes:

(1) Sustained severe budget deficits. In addition to letting the automatic stabilisers (lower tax revenues and higher welfare expenditures in a recession) take effect, most governments have tried to counter the crisis with

- (a) massive fiscal support for the financial sector (capital grants, loans, guarantees) with still uncertain effects on the government balance and
- (b) fiscal stimulus packages which increase public deficits (whilst having uncertain effects on sustainable growth).

(2) Population ageing. These crisis-related deficits are occurring as (especially European) societies face another fiscal challenge that will, in the long run, put even more stress on public finances: rapid population ageing. According to recent IMF estimates, the present value of these fiscal burdens might be ten times larger than the deficits attributable to the present recession (IMF 2009).

Obviously, such scenarios pose an imminent but also ongoing challenge to European policy-makers both on the national and the EU levels. A return to fiscal stability as defined by the Stability and Growth Pact seems an increasingly surreal notion, especially for some EU Member States that might come close to insolvency (bond markets have to some degree been factoring in the fear that even some weak Eurozone members might default on their bonds).

Many governments worldwide will be tempted to use a less harsh and less visible means of slashing their real debt: inflation. The ECB, under its present mandate, seems unlikely to yield to this pressure. However it will face the grave difficulty of reducing the massively increased liquidity by raising interest rates at the right time without stalling the recovery.

If defaulting on or ‘monetarising’ away public debt is not a viable option, a long-term strategy for escaping the debt trap is needed. Such a strategy almost necessarily involves short-term and, hence, electoral pain in order to avoid long-term economic decline. However, there are feasible proposals for and empirical examples of a successful return to stability.

The required fiscal adjustments vary substantially across European countries. They depend not only on the absolute amount of debt of a given country. The need for fiscal correction also depends on many other aspects, such as economic growth potential, the nature of public expenditures (investment or consumption), the liquidity of bond markets and, not least, the sustainability of social security and public health systems under the pressure of demographic change.

In part 2, which follows, I present an analysis of public debt in the EU. I begin with a few necessary definitions (2a), give the facts and figures of the status quo (2b) and outline various forecasts and scenarios. The facts and scenarios thus presented may be overwhelming, but they are by themselves simply abstract numbers that need to be interpreted with the aid of economic theory (and common sense). In part 3, therefore, I first dispute the very comforting macroeconomic national account logic according to which, under ideal conditions, public debt would entail no fiscal

burden (3a). Public debt, under real conditions, does imply a substantial burden on most members of future generations: taxpayers, consumers, employees, entrepreneurs and future governments (3b, 3c). Part 4 is devoted to the critical question of how to escape a debt trap. The seemingly obvious answer, higher taxes and lower expenditures (4a, 4b), will turn out to be too simplistic and static in many respects. Thus, I focus (in 4c and 4d) on ways to boost sustainable growth (increase public revenues) and to create sustainable social security systems (prevent a deterioration of public expenditures). For governments seeking re-election in much shorter time periods than needed for consolidation efforts to display their long-term benefits, inflation might be a tempting way out of debt, but it is a certain path to economic decline (4e). Therefore I conclude by discussing ways of establishing credible political commitments in advance that would allow (future) governments to limit the burden for future generations (4f).

A short summary of the main conclusions and recommendations ends this report.

2 Public Debt in the EU: Facts and Scenarios

a) Definitions: the Composition of Public Debt

Public debt is commonly defined as ‘an obligation on the part of a government unit to pay specific monetary sums to holders of legal claims at particular points of time’ (Buchanan

2000, 343). Not all public obligations can be directly inferred from budget statistics. Often, important future obligations associated with public pensions or social security are off-budget, so-called implicit debt, although, very much like the visible 'explicit' debt, they represent legal obligations due to political commitments and a fiscal burden on future generations. Some of these implicit obligations will be quantified below.

In order to provide a complete picture of both explicit and implicit public indebtedness, debt is best compared to wealth or, as is most common, to Gross Domestic Product (GDP). The absolute numbers of public debt may well increase, but if GDP increases even more, a state or an economy can be said to be less in debt. Thus, when Article 126 of the Lisbon Treaty (Article 104 of the TEC) demands that 'Member States shall avoid excessive government deficits', the ('Maastricht') criteria for excessiveness are defined as ratios relative to GDP.

As part of the Stability and Growth Pact enacted with the Maastricht Treaty, there are two reference values for two different dimensions of public debt: (a) 'planned or actual government deficit' (Art. 106, 2a) and (b) 'government debt' (Art. 106, 2b). Protocol No. 12 annexed to the Lisbon Treaty defines the respective limits as 3% (deficit/GDP) and 60% (debt/GDP). It also defines 'government' in an encompassing way as 'central government, regional or local government and social security funds'; 'deficit' is defined as 'net borrowing' and 'debt' as 'total gross debt at nominal value outstanding at the end of the year'. I follow these definitions and talk of 'deficit' in terms of planned or actual net borrowing during the fiscal year and of 'debt' in terms of the sum of all past and present accumulated budget deficits. In economic terms, deficit is thus a 'flow variable' (measured over a period of

time, a fiscal year) and debt is a 'stock variable' (measured at a point in time).

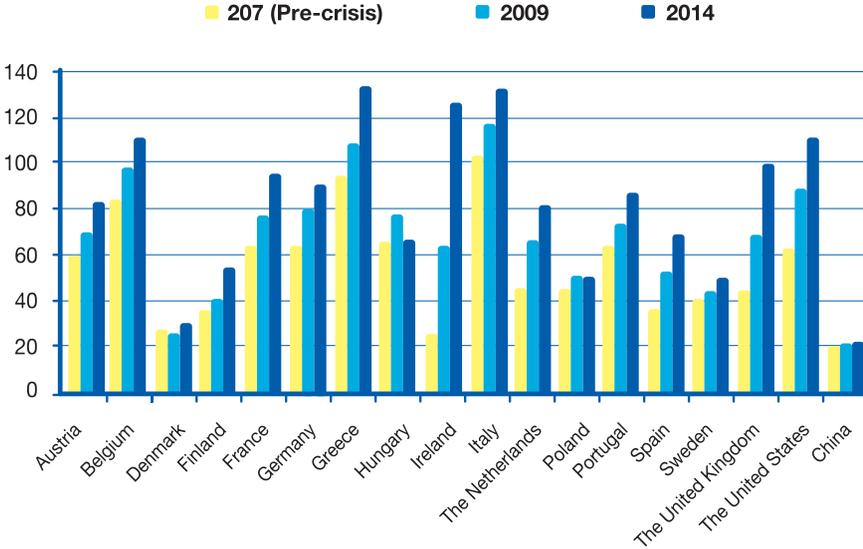
The following discussion of the causes and consequences of public debt will necessitate further distinctions between, for example, 'internal' and 'external' debt, 'structural' and 'cyclical' deficits, the 'primary' and 'total' budget or public 'consumption' and public 'investment'. I define these terms below when their relevance becomes clear. As a next step, I take stock of the current situation and explore various forecasts and scenarios for the development of public debt.

b) The Status Quo 2009

Already in 2007, before the financial and economic crisis originating in the US, many countries within the EU-27 and the Euro-16 had run current deficits and accumulated public debt that had to be regarded as excessive according to the Maastricht criteria and thus European Law. Although some efforts towards fiscal consolidation were made during the pre-crisis years, the budgetary costs of the crisis will certainly result in historically high debt ratios in most parts of Europe this year (2009).

As Figure 1 shows, major EU Member States will fail to meet the Maastricht reference value of a maximum of 60% debt-to-GDP ratio in 2009. In the EU as a whole, the debt ratio is projected to reach about 73.0% by the end of 2009 (78.2% in the Euro area)—which is still lower than the projected 89% in the US. However, the debt ratio levels differ significantly within the EU. In two Member States (Italy and Greece), accumulated debt will even exceed their GDP.

Figure 1: Public Debt-to-GDP Ratios 2007, 2009, 2014



Source: IMF (2009), European Commission (2009a).

With respect to the Maastricht deficit criterion (3% of GDP), the EU average will be exactly double that threshold, as Table 1 shows. This would still be ‘only’ half of the US budget deficit expected for 2009 (IMF 2009, 26). Still, for the first time, no single EU Member State will be able to report a balanced budget. Latvia, Ireland and the UK are even expected to have deficits of more than 11% of their GDP.

Table 1: Budget Balances of EU Member States (% of GDP)

	Budget balance					Structural balance			
	2006	2007	2008	2009	2010	2007	2008	2009	2010
BE	0.3	-0.2	-1.2	-4.5	-6.1	-1.5	-2.2	-3.2	-4.0
DE	-1.5	-0.2	-0.1	-3.9	-5.9	-1.2	-1.2	-2.4	-3.9
IE	3.0	0.2	-7.1	-12.0	-15.6	-1.8	-7.5	-9.8	-12.2
EL	-2.8	-3.6	-5.0	-5.1	-5.7	-4.5	6.5	-5.7	-4.7
ES	2.0	2.2	-3.8	-8.6	-9.8	1.6	-3.9	-6.8	-8.2
FR	-2.3	-2.7	-3.4	-6.6	-7.0	-3.9	-4.3	-5.5	-5.5
IT	-3.3	-1.5	-2.7	-4.5	-4.8	2.9	-3.4	-2.6	-2.8
LU	1.4	3.6	2.6	-1.5	-2.8	0.9	2.0	0.6	0.1
NL	0.6	0.3	1.0	-3.4	-6.1	-1.0	-0.5	-2.6	-4.3
AT	-1.6	-0.5	-0.4	-4.2	5.3	-1.8	-1.8	-3.2	-3.8
PT	-3.9	-2.6	-2.6	-6.5	-6.7	-3.3	3.8	-5.5	-5.1
SI	-1.3	0.5	-0.9	-5.5	-6.5	-1.7	-2.5	-4.9	-5.2
FI	4.0	5.2	4.2	-0.8	-2.9	3.2	2.8	0.8	-0.7
MT	-2.6	-2.2	-4.7	-3.6	-3.2	-3.3	-4.9	-3.6	-2.8
CY	-1.2	3.4	0.9	-1.9	-2.6	2.7	0.1	-2.1	-2.1
SK	-3.5	-1.9	-2.2	-4.7	-5.4	-3.8	-4.7	-5.0	-4.7
EA-16	-1.3	-0.6	-1.9	-5.3	-6.5	-1.8	-2.8	-3.9	-4.7
BG	3.0	0.1	1.5	-0.5	-0.3	2.0	0.2	0.3	1.6
CZ	-2.6	-0.6	-1.5	-4.3	-4.9	-2.5	-3.4	-4.0	-3.7
DK	5.2	4.5	3.6	-1.5	-3.9	3.0	4.2	1.2	-0.4
EE	2.9	2.7	-3.0	3.0	-3.9	-0.8	-4.1	-1.0	-1.9
LV	-0.5	-0.4	-4.0	-11.1	-13.6	-4.5	-5.8	-9.5	-11.5
LT	-0.4	-1.0	-3.2	-5.4	-8.0	-2.8	-5.2	-4.3	-5.5
HU	-9.2	-4.9	-3.4	-3.4	-3.9	-5.5	-4.5	-1.7	-2.0
PL	-3.9	-1.9	-3.9	-6.6	-7.3	-3.2	-5.3	-6.0	-5.6
RO	-2.2	-2.5	-5.4	-5.1	-5.6	-4.4	-7.9	-5.2	-4.7
SE	2.5	3.8	2.5	-2.6	-3.9	1.9	1.7	-0.5	-1.9
UK	-2.7	-2.7	-5.5	-11.5	-13.8	-3.7	-5.6	-10.0	-12.2
EU-27	-1.4	-0.8	-2.3	-6.0	-7.3	-2.0	-3.1	-4.6	-5.5

Source: European Commission (2009a, 22).

Although the structural deficits (the part of the deficit which is not a result of the economic cycle and thus of the present crisis) are smaller than the headline deficits, they are still significant. Only Luxembourg, Denmark, Finland and Bulgaria are expected to reach their medium-term budgetary objective.¹ It must also be noted, however, that drawing an economically meaningful distinction between structural and cyclical deficits is by no means an unambiguous, straightforward exercise (see European Commission 2009a, 23).

At any rate, it comes as no surprise that most EU Member States are today running deficits well beyond those allowed by the Maastricht criteria. Already at the beginning of this year, the Commission was carrying out excessive deficit procedures (Art. 104 of the TEC) against nine countries. In October, nine more Member States were added. Although the Commission acknowledged that in all cases the crisis had created an exceptional environment, deficit procedures were opened. This was due to the fact that the deficits were far from the threshold (3% of GDP) and could not be regarded as merely temporary (European Commission 2009b).

c) Forecasts and Scenarios

A recent statement of the European Commission warns of an increase in the debt-to-GDP ratio for the EU, projecting that they may reach 84% in 2010 and 125% in 2020 (European Commission 2009d, 21). It is important to bear in mind that these forecasts were made under a strong (but not outright presumptuous) *ceteris paribus* assumption: no

¹ The medium-term objectives (MTO) for the budget position differ amongst the Member States. For most states it is in the vicinity of a balanced budget position.

policy changes. It seems quite likely that with these alarmist numbers the Commission wanted to issue a wake-up call, a call for serious consideration of an exit strategy that would end the spending spree in the near future. Looking only five years ahead, both the IMF and the ECB project that nearly all Member States will experience a massive increase in their debt-to-GDP ratios (see Figure 1 above). From 2009 to 2014 the debt ratio in Ireland might even double and in the UK it could surge by an unprecedented 45%. Several other Member States will experience a rise of more than 20% and some (Italy, Greece, Ireland) will even have to face accumulated debts well exceeding their annual GDP.

These numbers reflect, of course, the current crisis as it leaves its mid-term mark in current deficits. According to the European Commission, average budget deficits of all EU Member States combined will amount to 7.3% of GDP by 2010 (Table 1). However, not every Member State will be affected to the same extent. Ireland has been badly hit; its current deficit will increase to nearly 16% in 2010. A similar situation is expected for the UK and Latvia, with budget deficits exceeding 13% of GDP. Mid-term projections of public deficits hinge, however, on unprecedented contingencies. Most European governments have taken non-budgetary measures to support their banking systems. Equity purchases, asset swaps, loans or guarantees to ailing banks will not necessarily have a fiscal impact; the precise effect is very hard to anticipate. The recovery rates from a later sale of acquired assets may be higher, and the default probability (hence, loss) from guarantees and loans may be lower than was expected during times of panic in the financial sector. Whether the financial crisis is now effectively contained is still, however, a matter of debate. Hence, the final fiscal costs, the true budgetary consequences of these

rescue measures, are still very uncertain (European Commission 2009a, 146; IMF 2009).

The aforementioned forecasts by both the IMF and the European Commission try to include 'parallel' or 'shadow' budgets that some governments are still using to hide their true balance sheet. However, the implicit debt and thus the implicit but nonetheless real burden for future generations are not yet fully reflected in these numbers. A full account of potential fiscal burden-shifting would have to include the full impact of demographic change, that is, the present value of the difference between future tax revenues and expenditures for public pensions, social pension funds, statutory health insurance as well as nursing care insurance. Using modern techniques of intergenerational accounting (see below), the Freiburg-based Research Centre for Generational Contracts estimated for the year 2004 that France and Germany each had accumulated an implicit debt-to-GDP ratio of more than 250%, which adds up to an overall debt-to-GDP ratio of about 315% (Generationenbilanz 2009, 10). With (a) little or no sign of positive demographic change, and (b) little or no pre-positioning of fiscal accounts to meet legal obligations for future generations, there is little or no hope that the implicit public-debt-to-GDP ratio will decrease in the absence of drastic reforms (see 4d).

In the EU, the old-age dependency ratio (the population older than 65 relative to the working-age population) is expected to increase from 25% in 2007 to 54% in 2060. Therefore age-related expenditures are expected to rise on average by 4.3% of GDP by 2060, which exceeds by far the impact of the current crisis on the fiscal accounts (European Commission 2009c, 21). As shown in Table 2, the net present value of the impact on the fiscal budget of age-

driven spending is expected to be nearly eleven times that of the financial crisis in the advanced G-20 countries. The table shows that Canada and Korea, for example, have been less badly affected by the current crisis than have other G-20 countries, but they carry a much higher age-related fiscal burden. Within the EU, the crisis has struck the UK hardest of all G-20 members, but the present value of the fiscal burden of ageing is considerably less than it is in Spain, for example (and somewhat less than the G-20 average).

Table 2: Net present Value of the Impact of the Crisis and ageing-related spending on the Fiscal Deficit (in per cent of GDP)^a

Country	Crisis	Ageing	Crisis/Ageing
Canada	21	726	2.9
France	31	276	11.2
Germany	29	280	10.3
Italy	35	169	20.7
Japan	35	158	22.3
Korea	20	683	2.9
Spain	39	652	5.9
UK	48	335	14.2
USA	37	495	7.5
Advanced G-20 countries	35	409	10.8

^aThe third column gives the ratio of the first column to the second column in per cent. The discount rate used is 1% per year in excess of GDP growth for each country. Given that real growth is expected to average 3% per year, this is equivalent to applying an average real discount rate of 4% per year. The averages are based on PPP GDP weights.

Source: IMF 2009, 44.

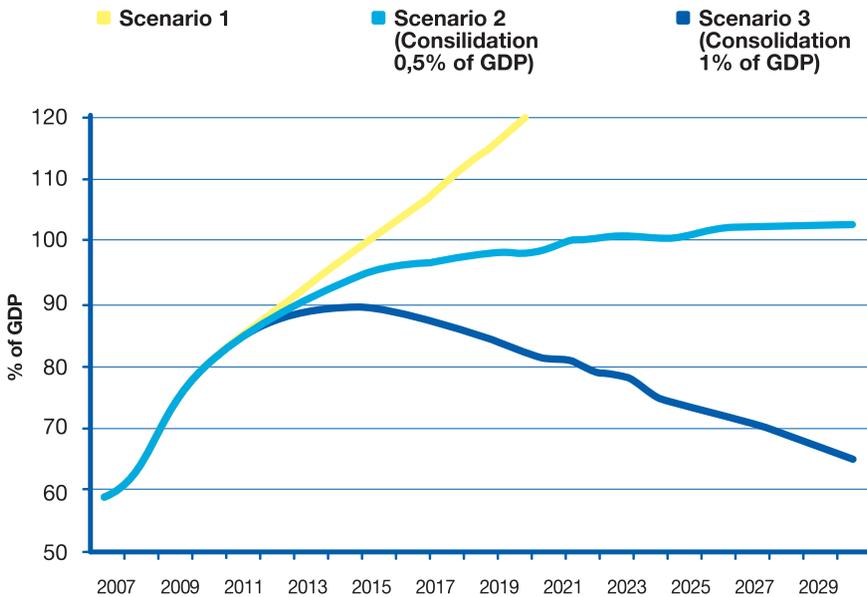
The EU Council of Finance Ministers agreed in June 2009 that fiscal policies should shift back to consolidation as soon as the recovery is on its way. However, as Table 2 above already suggests, economic recovery from the present crisis

is not likely to solve the lasting fiscal sustainability problems of most Member States. This can also be illustrated with the help of another sustainability criterion. The 'required primary balance' (RPB) represents the structural (non-cyclical) budget balance needed to meet the liabilities (due to costs of ageing and interest on the debt) once all other spending has been covered. For numerous Member States the RPB to keep public finances sustainable would by far exceed what is politically and socially feasible (e.g., Luxembourg would require a primary balance surplus of 13.6% of GDP from 2011 to 2015 in order to cover its future implicit debt). Hence for countries with a particularly large RPB, purely budgetary consolidation efforts will not suffice; reforms of demographically driven spending categories (pensions and healthcare) become crucial (European Commission 2009c, 11, 39).

In its recent sustainability report, the European Commission (2009c) presented three debt scenarios for the EU until 2030 (see below, Figure 2). The scenarios are based on several basic, perhaps even optimistic, assumptions, such as a return of growth to its long-term trend. A further optimistic assumption is the discontinuation of stimulus measures in 2011. The graph of the worst case, scenario 1, shows the development of the public debt ratio without any efforts towards consolidation. The average debt-to-GDP ratio would dramatically increase. By 2015, the debt-to-GDP ratio would exceed 100% and still be rising. The highest debt ratio would occur in Ireland and Latvia and only a small group of Member States would be able to stay within the Maastricht debt criterion of 60%. In the other two scenarios all Member States would undertake consolidation efforts of 0.5% of GDP or 1%, respectively, until they reach their medium-term objectives. The efforts starting in 2011 are

measured in terms of the structural primary balance. Indeed, Table 1 shows that it seems far from obvious that there will be any chance of a positive structural primary balance for all Member States from 2011 on (for 2010 a structural primary deficit of 5.5% of GDP is projected). The graph of scenario 3 indicates that a consolidation effort of 0.5% of GDP would not be enough to stabilise or even reduce the debt ratio by 2030. Only a tough consolidation effort of 1% of GDP would be able to bring debt back down after 2016. Nevertheless the debt-to-GDP ratio in 2030 will still remain above the 60% reference value and hence larger than the pre-crisis level (in 2007 it was 58.7% for the EU-27). It does become obvious that debt reduction would require severe consolidation efforts (European Commission 2009c, 55f.).

Figure 2: Medium-Term Debt Projections under Three Different Assumptions (% of GDP)



Source: European Commission (2009c, 56).

3 The Consequences of Public Debt

In the Victorian age, fiscal prudence in the sense of sufficient savings and the maintenance of capital was a common virtue, expected both in the private and public domains. This attitude of fiscal conservatism amongst private households, governments and economists changed dramatically in the early 20th century. Even before Keynes, economists started to develop the idea that, after all, 'we owe it to ourselves', meaning that at least internal debt (government borrowing from its own citizens) would not create a burden for future generations but simply implied a transfer of income from one group (taxpayers) to another (bondholders). With the success of Keynesian macroeconomics, economists' views changed even more and identified saving as responsible for a lack of effective demand, and debt-financed spending as a way to stimulate the economy. Through the 1960s and '70s, the views of academic economists changed slowly towards the earlier verities. However, 'public and political attitudes lagged behind those emerging in academia' (Buchanan 2000, 367) and Keynesian recipes for heavily debt-financed government spending (which might have been adequate for the 1930s which formed the background of Keynes' not really 'general theory') created the era of permanent and increasing public deficits which have lasted until today.

a. 'We owe it to Ourselves'?

The view that public debt would create no burden on future generations can be criticised in the first instance on methodological grounds. Such a view implies the 'organic

fallacy ... that treats the economy or the community as a unit' (Buchanan 2000, 430). But those who issue debt (politicians today) are not the same politicians who will, someday, have to ask their constituencies to repay the interest or the principal of the debt (politicians tomorrow). And citizens who hold claims on public debt (holders of government bonds) are not the same citizens who will have to bear the various burdens of debt put on their shoulders by others (see below). To aggregate claims and obligations across 'society' or 'the economy' in some national balance-sheet logic would in fact only make sense in a perfectly totalitarian system that knows of no distinction between state and society, public and private, present and future (for a more detailed discussion, see Vanberg and Buchanan 1986).

Even if one abstracts from these methodological fallacies, for a macroeconomic model to contest a fiscal burden, the following heroic assumptions must be made: (a) all public debt is 'internal', in other words, there is no borrowing from abroad; (b) the public expenditure financed by public deficits is not for current consumption, but capital spending for durable goods that yield services over the long term; and (c) such public investment does not 'crowd out' private investment; or if it does (d) public capital spending is at least as efficient in yielding future income streams as private capital spending would have been.

All these assumptions have been challenged by modern economics, thus yielding a theory of debt incidence that can help identify who will bear the burden of public debt.

b. Fiscal Durden I: Future Taxpayers and Future Governments

In contrast to the organic model of the economy consisting of one present and one future generation, modern theories of public finance rely on models of ‘overlapping generations’ taking into account that several different generations coexist simultaneously. This allows for generational accounting as a method for measuring the effect of fiscal policies on the present value of all taxes paid and benefits received by members of each generation (Rosen and Gayer 2008, 468ff.). Such models reveal that even if all debt were internal, an increase of current deficits does create victims: the youngest generation is at the short end of debt-financed expenditures since it will have to contribute to repaying a debt from which it never benefited. The only and truly rare exception to such a shift of burden to future tax-payers would be the case of productive investments that generated sufficient benefits over the relevant period to compensate for the tax burden. Different methods of generational accounting produce different amounts of fiscal burden shifted onto the future generations. But the general thrust of these calculations—for example, of future net tax burdens (the present value of benefits and/or transfers received minus the present value of the tax burden)—suggests that current generations are shifting a substantial burden to future generations (Kotlikoff 2002; Raffelhüschen 1999).

The political economy of public deficits is rather easy and straightforward: governments want to be re-elected. Voters like transfers and infrastructure, but they do not like to pay taxes. In order to please voters, governments thus are highly motivated to spend (or to grant tax exemptions with similar fiscal consequences) and have little motivation and no

obligation to cover expenditures by taxation. Both current donors (governments) and current recipients (voting taxpayers) are allies in their joint short-term desire to profit. Both have an interest in and perfectly legal ways of using, even squandering, other, future peoples' money for their own purpose. Both thereby impose extra burdens on future generations. Not only future taxpayers but also future governments are forced to pay for the debt-financed spending sprees of their ancestors. In many EU Member States, debt servicing (paying the interest, principal and refinancing of public debt) has become a very substantial part of public expenditures that drastically paralyses future voters'—and thus future governments'—ability to redefine their own political priorities with fiscal means.

c. Fiscal Burden II: Private Investors and Future Generations

The economic logic goes further. When governments spend money, whether financed by taxes or by borrowing, they remove resources from the private sector. This is most obvious in the case of taxation which involves a direct transfer to the treasury from private wage earners, consumers or investors. But also, when government borrows, it competes for funds with its citizens, with individuals and firms who would have used the money for their own investment projects. To the extent that a share of government spending is on current consumption and not on capital investment, debt finance almost certainly leaves future generations with a smaller capital stock (Buchanan 2000, 365ff.).

This is just another dimension of the fiscal burden for future generations (and governments): with a smaller capital base than would otherwise have been created, future

citizens will be less productive and have smaller real incomes. This effect is only partly reflected by the macroeconomic concept of ‘crowding out’ private investment as a consequence of public borrowing. In a narrow sense, crowding out does not refer to taxation or regulation (both of which may discourage private consumption and investment), but to competition on credit markets. When governments increase their demand for credit, the interest rate is likely to be higher than it would be without increased public demand for credit. As a consequence, private investment becomes more expensive and less of it is undertaken.

The sheer amount of crowding out (both in a narrow and a broader definition) is difficult to measure and heavily disputed amongst economists. In a recent study, Ardagna, Caselli and Lane (2007) collected cross-country evidence from 16 OECD countries covering a maximum time span from 1960 to 2002. They found that a one percentage point increase in the primary² deficit-to-GDP ratio is associated with a 10 basis point rise in the nominal interest rate on 10-year government bonds. In short, public deficits do increase interest rates. The authors also found that the effect of public debt on interest rates is ‘non-linear’: only for countries with above-average levels of debt (as is the case with most EU countries) does more public debt also increase interest rates (with above-average increases).

On globalised financial markets, crowding out becomes even more messy and more multi-dimensional. Higher

² The authors use the primary rather than the total budget, which means that interest payments are taken off the public balance sheet. The rationale is that autonomous changes in fiscal policy are better captured if the direct effect of interest rate changes on the budget itself is not part of the correlation.

interest rates attract funds from abroad. This, in turn, leads to an appreciation of the domestic currency and makes exports more expensive. As a consequence, exports are also crowded out. Countries with comparatively high debt and thus high interest rates very often show both signs of crowding out: low private investment and high current account deficits. To be sure, the crowding-out effect depends on many variables. One of the most important is the nature and marginal efficiency of government spending. Ahmed and Miller (2000) show that governments of developing countries that invest in transportation and communication can stimulate private investment (crowding in) whereas government expenditures on welfare, defence and redistribution reduces private investment in both developed and developing countries (crowding out).

The balance between crowding-out and crowding-in effects thus very much depends on variables that differ from country to country, even within the EU. The most important variables are the nature of debt-financed expenditures (investment or consumption), the given level of debt-to-GDP and the realistic prospects for economic development. In all three respects, most EU Member States (and: especially the old EU-15 or present Euro-16) have reached both a level and a composition of public debt that must be regarded as very close to or far beyond thresholds of negative present-value marginal returns of public expenditure seen from the perspective of future generations.

As we have already noted, a discussion of crowding out based only on current interest rates, exchange rates or fiscal measures is still very much focussed on the given macroeconomic aggregates and thus on the shorter run. In the longer run, demographic changes (i.e., declines) of these

aggregates will have to be taken into account. A crowding out of the capital stock available in the future is bad enough for future European governments and citizens facing stressed budgets. The demographic decline of the available numbers of the working population needed to pay back the accumulated debt—and at the same time take care of themselves and their families—makes the task even more challenging.

In short, there is a real and serious problem. Public debt, especially in mature European welfare states, is without a doubt a serious accumulated burden on future generations. And these future generations will, in most European countries, be less numerous and thus more burdened. This presents an urgent issue of intergenerational social justice. Fiscal conservatism is the most natural way to meet this challenge. And it can become a most convincing answer if it (a) succeeds in framing the new social question in terms of intergenerational justice and (b) engages in policies are credibly committed to effectively avoiding the debt trap.

4 How to Escape the Debt Trap

There are not very many reliable options for governments that aim to escape that debt trap. In purely budgetary terms, governments, like private households, can either increase revenues (taxes, fees) or cut expenditures. In addition, however, since public policies have a substantial impact on economic growth at large, governments can and should aim to promote national income—thus increasing the national

tax base and reducing the debt-to-GDP ratio. Furthermore, since public debt (especially off-budget and implicit debt) would also include fiscal social security obligations, reforms of pension and healthcare systems would also have an impact on future expenditures and thus on public debt.

From an economic point of view, the preferred ways would be those that increase efficiency in public spending and taxation, thus enabling market-led sustainable growth of the economy. With this prerequisite in mind, I discuss five options for how to curb public debt: (a) higher taxation, (b) lower expenditures, (c) more growth, (d) more sustainable social security and (e) higher inflation. As a procedural recommendation related not to ‘*what* can be done’ but to ‘*how* it can be done’ I add (f), institutional pre-commitments to balanced budgets.

a. Higher taxation: Europe Near the Slippery slope of the Laffer Curve

One of the main reasons why under normal conditions government bonds can almost always be sold in order to finance a current deficit (and usually at lower risk premiums than private borrowing) is the state’s monopoly on the power to tax. Governments are different from a private debtor because they can, within flexible limits, force others, their citizens, to cover the bill. However, there is a non-monotonic relation between higher tax *rates* and higher tax revenues. Increasing tax rates by a certain per cent does not mean increasing tax *revenues* by an equal per cent. The market logic applies to taxes as it does to other prices. A company (state) that experiences losses (deficits) cannot simply increase prices (taxes) in order to balance its budget. The price elasticity in

competitive markets for private goods and services is certainly in most cases higher than the tax elasticity on 'markets' for public goods and services. Still, raising taxes and thus non-voluntary payments can also lead to reactions from taxpayers that will yield much lower tax revenues than expected.

The basic explanation for a non-monotonic relationship between tax rates and tax revenue can be illustrated by the Laffer curve. It starts from a very intuitive insight: if tax rates were at 0%, there would, obviously, be no tax revenues. If tax rates were at 100% (absent slavery or a totalitarian duty to work), tax revenues would also be absent. Hence, there must be a tax rate that maximises tax revenue (the combination of tax rate and taxable base). Beyond a certain threshold (the peak of the Laffer curve), government is on the slippery slope, which means that increasing the tax rate reduces tax revenue. Thus, higher taxation as a means to consolidate public debt may become self-defeating: tax revenue may in fact decline and, even more, so might economic growth—both leading to worse debt-to-GDP ratios. Just where the exact tipping point (the maximum of government takings) may lie is an academically fascinating and politically delicate question. In different tax brackets different jurisdictions have experienced or are bound to experience different reactions from their citizens (or tax base): taxable income can escape the fiscal burden by choosing to 'exit' to (a) other jurisdictions (employing resources elsewhere), (b) the shadow economy (employing resources tax free) or (c) apathy (reducing the employment of valuable resources).

As a general rule of thumb it can be said that the higher the existing tax burden already is and the easier it is to exit, the more likely it becomes that increasing tax burdens for present generations will not help to balance the budget but rather will increase tax burdens for future generations. In recent studies,

Trabandt and Uhlig (2006 and 2009) have tried to position EU countries and the US on a Laffer curve. Their results (based on a neoclassical growth model, the details of which are to be found in the papers) can be summarised as follows:

In terms of most taxes for most EU members, at least in the short run, we are still on the left side of the Laffer curve (meaning that higher taxes would also yield higher tax revenues). However, since 1975 the EU-15 zone has moved considerably closer to the peaks of their Laffer curves—and much closer than, for example, the US. As a consequence, US budget deficits are more likely to be balanced by way of tax increases than the deficits of most EU Member States. If the EU-15 were to concentrate on long-term efficiency gains and thus on growth, in the EU-14 economy (excluding Luxembourg) 54% of a labour tax cut and 79% of a capital tax cut would be self-financing.

Thus, for the treasury, tax cuts would not be completely self-financing (a ‘free lunch’), but still considerably so (a ‘cheap lunch’). For some countries and some tax instruments, lower taxes would even yield—by way of an increased tax base—higher tax revenues. Labour taxes in Sweden seem to be a case in point (see Jonsson and Klein 2003). Especially for taxes on capital income, increasing the fiscal burden could lead to a drastic, perhaps even offsetting, reaction of the tax base—thus creating no or even negative effects on the long-term public budget. As Trabandt and Uhlig (2006, 27) summarise: ‘in the case of capital taxes the EU-15 economy has moved almost exactly to the top of the Laffer curve’.

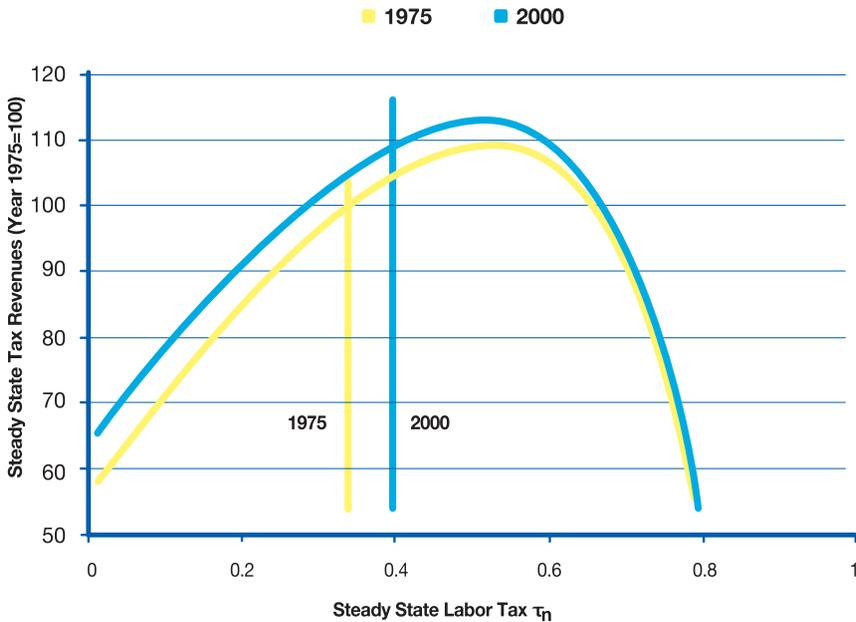
Consumption taxes, however, show a lower elasticity and would therefore be, from a purely budgetary point of view, more promising candidates for attempts to raise public revenue. Even

members of the old EU-15 constitute no coherent whole that would be even roughly evenly located on a Laffer curve. For capital taxes, Trabandt and Uhlig (2009, 25f.) put Ireland at a larger distance from the curve's peak than the US (meaning that higher capital taxes might yield higher tax revenues) whereas the Netherlands, Finland, Belgium, Sweden and Denmark are located on the slippery slope of their Laffer curve (meaning that higher capital taxes would yield lower tax revenues).

In short, higher taxes today do not mean lower debt tomorrow. A sustainable strategy of debt relief cannot simply rely on higher tax rates. A broadened tax base combined with lower tax rates may be growth-enhancing and thus budget-consolidating in some areas for some EU countries (see also 4c below). The shift from burdening a tax base that is most evasive (capital) to one that has very few exit options (consumption) would also be most rational for every economist in charge of the public purse. The economist-turned-finance-minister would take advantage of the liberty that she or he would scarcely have as an entrepreneur in the private realm regulated by anti-trust regulations, to use price discrimination and charge higher prices (taxes) for those who are least able and likely to exit. He or she would, however, thus be able to maximise 'profits' (tax revenue) or to avoid 'insolvency' (the public debt trap). Taxing consumers and letting capitalists off the hook would, of course, be the most devastating policy in terms of re-election prospects. In terms of long-term public deficit management, however, it would be right on target: this shift of the present burden could create future relief. By encouraging current private saving and capital formation, future generations would have more substance to inherit and at least a chance to repay the debts their (grand) parents have accumulated.

Box1 Some elucidations of the Laffer-Curve

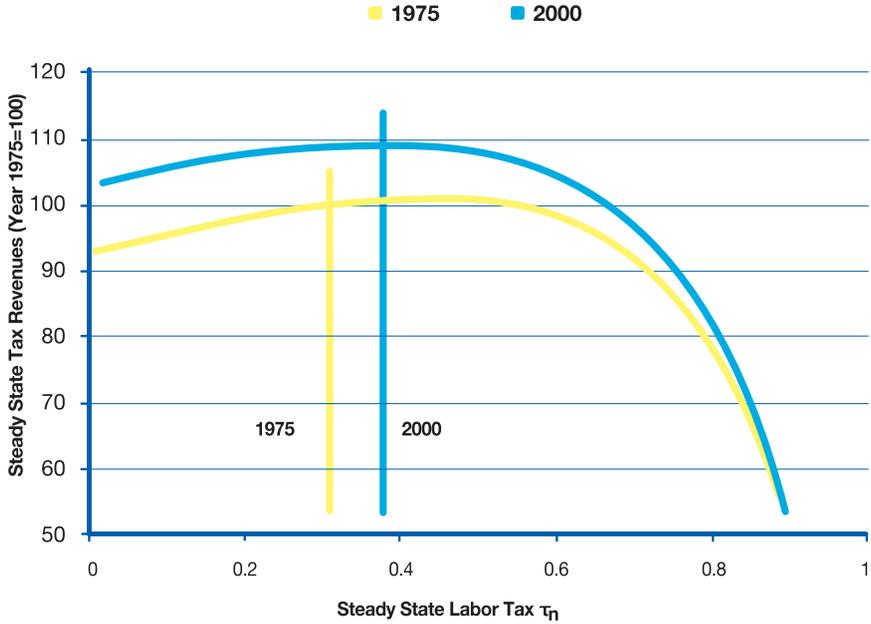
BOX 1 - Figure 1: Labour Tax rates and Public revenue



Source: Trabandt and Uhlig (2006, Figure 5). For all details consult the specifications of the model.

The above figure shows that as tax rates on labour increase (from left to right), tax revenues at first rise, then reach a maximum and later decline. The EU-15 tax rate in 2000 was around 40% (0.4) and is further increasing to 41.3% in 2007. The point at which a further tax increase would lead to decreasing tax revenues is around 50% (0.5). The upward shift of the Laffer curve from 1975 (blue) to 2000 (red) indicates that with the same tax rate higher tax revenues can be generated (due to an increased tax base). The graphs below show the 1975 and 2000 Laffer curves for taxes on capital. EU-15 countries, on average, moved almost exactly to the top of the curve. The relatively flat slope of the curves' section left of the tipping point means that tax reductions would not greatly reduce tax revenues. The relatively steep decline of the curve to the right of the tipping point means that tax increases beyond that point will quickly lead to tax evasion and a reduction of revenues from capital taxes.

BOX 1 - Figure 2: Capital Tax rates and Public revenue



A further increase in labour and capital taxes in the EU countries would not have a huge impact on tax revenues. The EU-15 countries can increase tax revenue by 8% by raising labour taxes and by only 1% by raising capital taxes. Compared to that, the US is in a much better position with 30% and 6%, respectively (Trabandt and Uhlig 2009, 26f.).

b. Lower Expenditures: the Fiscally Conservative way out of the Debt Trap

Cutting expenditures if one is in debt is the most natural reaction of all responsible individuals spending money on their own behalf or on behalf of their families. In the political realm, with agents spending other peoples' money for other peoples' demands, such an obvious reaction to a budget constraint is not as present as it would be (under strict rules of private law) in the private domain. Even if it might be equally reasonable, it is not equally feasible. After all, the unique attribute of government (in contrast to a family) is that it can coerce unknown and unborn others to pay the bill. And, as argued above, present voters like to see the benefits of government expenditures and have others pay for it.

Cutting public expenditure is thus a very demanding and quite likely self-defeating strategy for current governments aiming at re-election. Public expenditures as a share of GDP have increased almost constantly since the Second World War within the EU-15 (in so-called old Europe). And they will most likely continue to do so, as the scenarios of the IMF or the European Commission suggest (see 2c). The sheer proportion of public expenditure as a part of GDP is not, however, a reliable indicator of a country's competitiveness or of the sustainability of its public finances. Some Scandinavian countries, for example, were able to support a huge public sector without falling back in terms of growth or becoming a semi-socialist system on the brink of fiscal collapse.

But that might not be true for the EU as a whole. Gwartney, Lawson and Holcombe (1998), in a report for the US Congress, summarise a large-scale series of empirical

studies as follows: ‘there is overwhelming evidence that both the size of government and its expansion have exerted a negative impact on economic growth during the last several decades’—both in the US and the OECD world at large. Their reasoning is based on a differentiation between kinds of public expenditure:

Government provision of both (a) a legal and physical infrastructure for the operation of a market economy and (b) a limited set of public goods can provide a framework conducive for economic growth. However, as governments move beyond these core functions, they will adversely affect economic growth because of (a) the disincentive effects of higher taxes, (b) diminishing returns as governments undertake activities for which they are ill-suited and (c) an interference with the wealth creation process, because governments are not as good as markets at adjusting to changing circumstances and finding innovative new ways of increasing the value of resources. (Gwartney, Lawson and Holcombe 1998, v)

However one wants to interpret the empirical findings, it seems quite obvious that most of the fiscal strain experienced by European countries stems not from taxing too little, but from spending too much. And of all of their spending, too little is being spent in public expenditures that could safely be regarded as ‘investments’—as current expenditures for education, research and infrastructure and thus as investment in human and physical capital that will yield substantial future benefits and thereby provide a valuable bequest for future generations.

A reduction of public expenditure—especially of the consumption as opposed to the investment type—would

thus have to be the fiscally conservative way out of the debt trap. This is more easily said than done—for an economist as much as for a politician. The potential for cutting expenditures most certainly varies amongst EU Member States. Also, the European Union budget itself cannot easily provide a model of how investment-like expenditures (on research, basic infrastructure or education) should dominate consumption-like expenditures (on agriculture, bureaucracy or redistribution).

c. More Growth: Fiscal and Regulatory Ways to let the Market do its Job

Investment, and especially private investment within the rules of a Social Market Economy based on secure private property rights, freedom of contract, personal liability, open access to markets (and, thus, competition) and coordination via market prices, has always been the basic cause of the wealth of nations.³ If European nations were to follow the advice of many of their intellectuals and abandon ‘capitalism’ (i.e., the market order based on a private law society) and move further in the direction of a regulatory welfare state that extracts vital energies from its citizens in exchange for public care, an increase of public debt would be the inevitable consequence of a likely collapse of the economic base.

Strong growth was a key source of debt reduction in most Western European countries after the Second World War—and it is the main reason why many emerging market

³ On the concept of the Social Market economy as ‘a way out of the crisis’, see EPP (2009).

countries have recently been very successful in reducing their debt (IMF 2009, 42). For the more advanced economies in the EU the following fiscal measures should be consistent with boosting their growth potential (see Daniel et al. 2006): (a) a shift from unproductive government spending to public expenditures that are likely to yield high-quality growth (education, transportation infrastructure, preventive health care), (b) distributional spending more targeted towards those in need and more directed at providing incentives to take up work and (c) a broader tax base combined with lower tax rates aimed at minimising distortions and improving incentives to invest (the bias in favour of debt versus equity financing, especially, ought to be removed).

In addition to these fiscal measures, there are many kinds of growth-enhancing policies that do not directly affect the public purse but, by way of better regulation, would most certainly help to boost growth (and thus public revenues). This is not the place to discuss and evaluate these measures—which are part of the yet unfinished Lisbon agenda.⁴ In many EU Member States, steps towards more flexible labour markets are needed to fight unemployment (especially amongst the young). And at the European level, the potential of the Common Market has not yet been fully realized. Especially in the increasingly important sector of private services and in areas of the knowledge economy, a more substantial opening up of the Common Market should yield increasing returns in terms of sustainable economic growth (see, e.g., van Ark, O'Mahony and Timmer 2008, who stress these areas as causes of a persistent productivity gap between the EU and the US).

⁴ See, e.g., President Barroso's eloquent listing of necessary 'actions to deliver growth and jobs' as a 'new start for the Lisbon Strategy' (European Commission 2005).

d. More Sustainable Social Security: taking Demographic Change Seriously

All the implicit debt reported above (3c) will soon, for future governments and taxpayers, become uncomfortably explicit. Particularly as the ratio of the population over 65 to the working-age population is bound to double by 2050, most EU Member States will face upward pressure on public spending for pensions, health care and long-term care. Again, the fiscal burden of ageing populations amounts to a present value of public obligations about ten times higher than the crisis-related deficits that presently dominate the discussion. In most EU countries, there has been no adequate pre-positioning of fiscal accounts for the demographic shock that is clearly unavoidable.

Entitlement reforms both for pensions and health care are unpopular, but postponing such reforms would only lead to larger and more painful adjustments in later years. Policies that increase the effective (and not only legally stated or enforced) retirement age should be the main tool to (a) stabilise the pension system and take some of the burden from the shrinking working-age population and, at the same time, (b) increase tax revenues and decrease tax subsidies. In addition, encouraging privately funded pension plans (even with the help of public subsidies) can, in the long run, be a profitable investment for both future pensioners and future taxpayers.

Pension reforms, if implemented and communicated early enough, can be quite effective in the long run. A recent study by Müller, Raffelhüschen and Weddige (2009) has calculated the effects of three major reforms of the German pension system (in 2001, 2004 and 2007). Each reform

substantially reduced the burden on future generations. Based on an indicator named ‘open-system net liabilities’⁵ the authors calculate the sustainability gap in the German pension system. Before the so-called Riester reforms of 2001,⁶ the gap was more than twice the size of the German GDP in 2006. After introducing a ‘sustainability’ factor⁷ into the rent formula (in 2004) and increasing the legal retirement age (in 2007),⁸ the gap was reduced to 88% of GDP. In short, the reforms were able to more than halve the present value of accumulated burdens.

Longer life expectancy due to technological progress in medical treatment is a great achievement of modern civilisation. However, it poses a serious challenge to modern welfare states based on the promise that all health care that is available will be provided for everyone who is in need, paid for by everyone who is working. As in the case of pensions, this laudable promise creates entitlements that, due to demographic change, are hardly sustainable. The solvency of health care insurers, of public budgets and, in both cases, of future generations, might require that types of

⁵ This is an extended indicator based on generational accounting. It comprises the present value of the capital stock that would be necessary to satisfy the claims accrued to date of private households, but also pension entitlements accrued in the future and future contributions.

⁶ This was to encourage private investments in pension plans by ways of public subsidies and/or tax privileges. France, Hungary and Poland have implemented similar incentive plans. See OECD (2009a, 85–95) for an overview of recent pension reforms.

⁷ This factor changes the size of pension benefits depending on factors such as average life expectancy at the time of retirement. Similar policies have been implemented in Slovenia, Finland, Italy, Portugal and Sweden (see European Policy Committee 2009, 31).

⁸ Germany aims at phased increases of the pension age to 67, the UK envisages a future pension age of 68. Denmark will increase the pension age to 67 and then link it to life expectancy.

services to be covered from the common (and shrinking) pool of net payers be limited. This evokes even more dramatic and morally intuitive trade-offs that need to be addressed today (see OECD 2009b on health care spending growth almost doubling economic growth and on reform options).

Box 2 Reforming European Social Models: Common and Different tasks ahead

As André Sapir (2005) put it, ‘the notion of a single “European Social Model” is largely unhelpful for thinking about reforms’. It would be far more helpful to think in terms of plural ‘European social models’ that can all be subsumed under the heading of a Social Market Economy (Art. 3 of the Lisbon Treaty)—an economic order based on freedom to operate in open markets (private property, freedom of contract, private liability and unfettered competition) as well as various forms of social redistribution (see EPP 2009, Goldschmidt and Wohlgemuth 2008). Why does the European Union demand of all its Members States common obligations to economic liberties, whereas social security or labour market policies are predominantly decentralised, the affair of the Member States?

This seeming incoherence can be explained and justified by many good reasons (see also Wohlgemuth and Brandi 2007) of which I will mention only two:

(a) The common market is, in economic terms, a dynamic positive-sum game; free trade is apt to yield benefits to anyone creatively involved whereas redistribution in the name of ‘social justice’ is all too often a zero-sum or even negative-sum game. Hence, overall consent is rather easily obtained and extended across borders when it comes to transnational liberties for everyone. It is far more demanding when it comes to the tricky case of transnational ‘solidarity’. Both political philosophy and political economy would thus recommend that

(b) questions of social justice, especially commitments within social security systems—that is, who is entitled to which kinds of benefits to be paid by which part of the population—are best left to decentralised jurisdictions where such collective decisions can be based on the principle of subsidiarity and thus reflect local dimensions of democratic consent, spontaneous solidarity and economic feasibility.

Hence, European Member States do and should differ substantially in terms of their social security systems—and the structural debt problems these involve. It would take a series of other papers to compare the different needs of EU Member States to adjust their policies and budgets to meet the implicit debt burdens of future generations. Differences amongst social security-related debt problems would certainly involve a combination of these three components:

(a) The level of accumulated debt. Some EU Member States (see above, 2b, 2c), both outside and within the Eurozone, are already finding it difficult to access short-term debt to finance long-term debt. Since a straightforward bailout from other EU Member States is, legally, still ruled out, the question

remains: How can these countries commit to reforms that engender trust on financial markets? The most urgent European cases today seem to be Greece, Ireland, the UK, Spain and Latvia (European Commission 2009a, 22). In the medium-term perspective, an answer depends on the growth prospects of these countries (the list of which could easily be enlarged) and on their political credibility and willingness to meet the following two challenges: demography and employment.

(b) The growth of age-related public expenditures (health care, long-term care and pensions). The decline of the economically active population relative to older age cohorts varies amongst EU Member States. The demographic part of the problem depends on a combination of fertility rates (average number of births per woman over her lifetime), life expectancy and net migration. In terms of fertility rates, some countries (e.g., the Nordic and Anglo-Saxon states, but also France) have considerably better prospects than others (e.g., Germany, Austria, Italy, Bulgaria). In terms of net migration, the Commission projects that immigration flows will be concentrated in a few destination countries: Italy, Spain, Germany and the UK. Many new EU Member States will for some time continue to see a net population outflow. All these factors affect age-related increases in public debt. However, policies can and should be tailored to meet these different challenges. The combination of demographic challenge and lack of political response leads to very different projections of long-term age-related increases in public expenditure. On the basis of current policies, these expenditures will by 2060 increase by more than 7.7% of GDP in Luxembourg, Greece, Slovenia, Cyprus, Malta, Romania, the Netherlands, Spain and Ireland. Mostly due to the implementation of substantial pension reforms, other countries such as Bulgaria, Sweden, Portugal or Denmark will face a more moderate increase of less than 4% (European Commission 2009e).

(c) The creation of competitive employment. Demographic change, the numerical decrease of the available workforce, will not by itself solve the problem of unemployment. As the EU moves from on average four persons of working age for every person over 65 to a ratio of only two to one in 2060 (European Commission 2009e), it becomes imperative that the remaining working-age population be fully and, what is more, most productively employed. This is why education and innovation, research and entrepreneurship, flexibility and ingenuity, have to become priorities for all levels of government action, both fiscal and regulatory. These increasing demands also relate to labour market policies. In recent years, various forms of 'flexicurity' have been quite successfully implemented in Nordic and Anglo-Saxon countries and endorsed by the European Union as a part of its employment strategy recommendations (e.g., European Commission 2007). Simply put, 'flexicurity' combines flexible labour contracts that enable a swift reallocation of human capital from declining to expanding firms and sectors with the assurance of an adequate income between jobs. Such employment strategies will become even more important in the future as traditional kinds of permanent employment with the same firm become less likely and less adequate in a dynamic knowledge-based, globalised world.

During an all-encompassing economic crisis, of course, flexicurity has to withstand a difficult stress test. As almost all sectors have been hit, many workers are being fired and only few are hired under flexible labour contracts. Also as a consequence of substantial unemployment benefits, public expenditure and public debt may for a while increase, especially in the case of flexicurity systems. Compared with the alternative model of labour tied up in government-subsidised firms and sectors and sclerotic labour markets characterised by artificial barriers to entry and exit, flexicurity should, however, in the long run turn out to be better at creating employment and easing the financial burden of future generations.

The IMF (2009, 45) concludes its analysis of the risk of fiscal insolvency and the appropriate policy response by saying that ‘times of crisis have in the past provided opportunities for enacting politically difficult reforms’. Areas of difficult reforms have just been mentioned. The most urgent challenges in the not too distant long run seem to require the most heroic willingness to reform cherished systems of welfare provision. Will political agents who seek re-election be willing to show such heroism? And are they likely to be rewarded? The last two sub-sections address these more fundamental questions.

e. Higher Inflation: an Easy way out of Debt- and into Economic Disaster

Historically, governments that run into a serious debt trap have often sought the easiest way out: inflating the currency. Inflation not only reduces the real value of accumulated public or private debt whilst imposing a seemingly innocuous ‘inflation tax’ on its creditors. Inflation, today, also increases public revenue by way of ‘cold progression’: that is, taxpayers in a progressive tax system increasingly end up paying higher taxes, although their ability to pay, in real income terms, has not changed at all.

Such a way out of the debt trap should only be attractive to Leninist cynics: John Maynard Keynes (1919/1971, 148f.) deserves to be quoted at some length in this context:

Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of

their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become ‘profiteers,’ who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery. Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.

Inflation, thus, is a deeply ‘unsocial’ method of implicitly expropriating those who have been saving parts of their income and wealth in order to take individual care of their own future—or that of their children and grandchildren. This is the moral dimension of inflation: Those who trust in government and its bonds or other privately contracted obligations will, by way of inflation, be taxed excessively and feel terribly fooled—but only once. As in the case of open default, both public and private, creditors’ willingness to save and lend money, thereby allowing for public or private debt-financed investment, would justifiably be discouraged.

In addition, inflation (the increase of money supply in excess of production potential) inevitably distorts the price mechanism; it leads to the misallocation of scarce resources and to overinvestment in specific sectors. Indeed, it can safely be argued that the present crisis (and most of the previous recessions) is due mainly to cheap money and cheap credit created, first and foremost, by the American Federal Reserve (Gjerstad and Smith 2009). At the moment, cheap money also means cheap credit costs for an exploding public debt. But in the not too distant future, excessive liquidity could mean ‘fighting fire with fire’ (Wohlgemuth 2008) and creating conditions for an even more dangerous credit-driven bubble. Some debt-financed (‘leveraged’) government action has been needed to bail out debt-financed (‘leveraged’)—and government-sponsored—overinvestment in markets for real-estate and financial derivatives. But who will be willing and able to bail out debt-trapped governments?

These delicate interdependencies frame the difficult task of timing and sequencing the needed policies in the budgetary, monetary and financial sector for exiting from the current crisis which cannot be discussed here.⁹ But reliable, perhaps also coordinated exit strategies are needed in order to avoid short-term political temptations to chop down the

⁹ Von Hagen, Pisani-Ferry and von Weizsäcker (2009) propose that governments should first complete the recapitalisation of ailing banks, then (in 2011) start consolidating their budgets whereas monetary authorities should not rush to the exit. The ECB, the authors recommend, should remain ‘supportive’, which means that monetary tightening (the increase of interest rates from their near-zero level, the reversal of quantitative easing) would have to wait until growth is well on its way. This makes macroeconomic sense in a comparative-static model; it might, however, underestimate the risk of creating new bubbles if close to zero interest rates no longer encourage saving but rather cheap credit and thus unsustainable over-investment.

apple trees for vote-winning firewood. Especially the fiscal policy exit, the return to sustainable budgets, might well be asking too much of ordinary politics—both on the demand side (present voters and beneficiaries) and on the supply side (political parties in permanent competition for votes). What is needed are commitments backed by institutions (rules of the game) that credibly close the door to the further accumulation of debt.¹⁰

f. Better Institutions: How to tame Leviathan

The history of fiscal policies, past and present, in democracies and autocracies, in Europe and elsewhere, suggests that there is an overwhelming temptation for governments to enrich themselves and/or their constituencies at the cost of others—namely, future generations. The attitude ‘spend now, pay (tax) later’ has become commonplace today. At the same time, there is still, I think, a deep-rooted common understanding of basic economic and moral (‘Victorian’) imperatives such as ‘one should not live beyond one’s means’ or ‘it is deeply unjust to leave to future generations an unbearable bequest of debt’. The fetching notion of ‘sustainability’ has worked well with regard to environmental policies. Concrete pictures of shrinking glaciers and icebergs may be more apt to catch the eye than abstract numbers of rising mountains of debt. But the flood of debt obligations is at least as threatening to the well-being of future generations as an increase in sea levels due to global warming may soon become.

¹⁰ See Wohlgemuth (2005) for various ways in which the ‘rules of the game’ of democratic politics can be changed in order to provide better results.

Both phenomena deserve at least equal concern and precautionary foresight—and equal consideration when we discuss issues of justice amongst generations under the label of ‘sustainability’. In both cases, credible commitments from present governments, extending to a future that far surpasses their immediate years of tenure, are required. Such credible commitments can hardly be expected from ‘ordinary politics’ (with voters and lobby groups having mostly their immediate interests and privileges in mind)—they have to come from general and lasting constitutional rules that may more easily command the consent of all citizens if situated behind a ‘veil of uncertainty’.¹¹ From a constitutional economics point of view (see Buchanan 2000), several intergenerational rules of just collective behaviour suggest themselves:

- (1) Future generations of taxpayers should be given some weight in current decision-making. Presently, there are voters and citizens. The former become politically relevant as soon as they reach voting age. At the same time, voters are becoming both increasingly old and increasingly childless. Hence precisely those citizens (children) whose tax money is now being spent are ‘disenfranchised’ (Buchanan 2000, 433). A reduction in

¹¹ This deeply Kantian heuristic has been proven to be the most persuasive in all non-authoritarian ideological camps (see Rawls 1971; Buchanan 2000, 502). What kind of general rules of justice would one want to be universally applied if one were completely uncertain whether one would be rich or poor, male or female, old or young (or born in the future) etc.? The results of such thought experiments do, of course, differ. But the very idea of passing on a fiscal (or environmental) burden to future generations would most certainly be dismissed by citizens who did not know if they would be members of present or future generations.

voting age does not solve the issue; it rather raises the issue of under-age competence. However, there is already the legal representation of a minor by parents acting as guardians. Why should they not also be allowed to represent their own children as ‘political guardians’ at the voting booth? Granting an additional vote for each of their children could transfer the ‘bequest motive’ (parents caring for their offspring) that still functions in most families at least partially into the realm of political decision-making.

- (2) Alternatively (or additionally) to changing the franchise, explicit constitutional constraints can act as safeguards against the biased interests of currently enfranchised citizens. Several such constraints are discussed – and have been implemented in several countries:
- a. One rather simple rule would be to require supermajorities in legislatures in order to authorise public debt.
 - b. The favoured constraint amongst economists is the ‘golden rule’ according to which the share of government outlay financed by debt should be equal to the share of investment in public capital. Thus, there would be an offsetting item on the nation’s balance sheet that would match the liability that the present value of debt represents (see Buchanan 2000, 371). Such provisions exist in many European countries (such as Germany) and are also partly reflected in reinterpretations of the Stability and Growth Pact. The problem is that these rules are very rational in theory, but very ineffective politically. Criteria such as ‘investment’ or ‘public capital’ can be very widely

interpreted—and they will be stretched beyond the limits of ordinary semantics if the players (governments) are also the umpires, that is, if no independent third party can interpret the facts and enforce compliance (see Wohlgemuth 2009).

- c. A politically more effective constraint would be a balanced budget constitutional amendment. ‘Spending without taxing’ would no longer be an option; governments would be forced to cover all public outlays by levying taxes. In other words, there would be a price tag on very (additional) expenditure; and current, not future, generations would have to pay the bill. For most present governments who already shift debt burdens to the future, implementing and immediately following such a rule could well be suicidal. In other words: ‘It is clearly more difficult to secure agreement on a change of the rules of any game while the game is being played than it is to secure agreement on a set of rules before the game starts’ (Buchanan 2000, 501). Therefore, it seems politically wise to seek agreement on new rules (balanced budget or otherwise) that will take full effect only in the future. This lagged full implementation puts the players (governments, voters, interest groups) under some ‘veil of uncertainty’ since their immediate distributional interests are not affected and the interests of future generations can to some degree be internalised when choosing general rules whose general benefits are obvious, both economically and morally.

The details themselves of such rules are, of course, much more complex and debatable. For a lagged implementation

of balanced-budget rules, for example, there should be a clear road map for the period of transition; there should also be some built-in flexibility for the automatic stabilisers to react to unforeseen recessions or surpluses.¹²

This is not only an academic debate. As noted above, some countries have quite successfully implemented such rules. This year, the grand coalition in Germany decided on a rather ambitious constitutional amendment that took many of the above-mentioned ideas into account. We will have to see whether these rules really work. A short and simplified account of this reform of fiscal rules may nonetheless be instructive and perhaps even model the kinds of rules and procedures that other European countries may want to emulate as ways of escaping the debt trap.

Box 3 Germany's New Fiscal Policy Rule: the Debt Brake

The new fiscal policy rule commonly called *Schuldenbremse* (debt brake) was the outcome of an all-party (all parties represented in the Bundestag) and multi-level (federal, state, communal) Commission for the 'modernisation of financial relations between the federal and state level' that started work in March 2007. Early in 2009, embedded in a more comprehensive reform package dealing with both vertical and horizontal fiscal relations in the German federal system, the debt brake was adopted by the Commission. The bill passed both chambers (Bundestag and Bundesrat) in May and June 2009 with the two-thirds majorities needed to change the German constitution.

The new Article 109 of the German constitution demands almost-balanced structural budgets: on the federal level, a maximum ratio of deficit-to-GDP of 0.35% has to be reached by 2016; governments on the state level have to comply with a zero per cent deficit rule by 2020. These rules apply only to

¹² Buchanan (2000, 507) argues that the rules might 'require only that the final budget resolution ... contain revenue and outlay estimates that are equal, as based on competently prepared and unbiased projections at the time of fiscal choice. If, subsequent to choice ... the macroeconomic setting should change so as to generate shortfalls or surpluses, these shifts, in themselves, need not be considered to violate the constitutionally mandated rules for maintaining budgetary balance.'

structural deficits (and not cyclical deficits that automatically arise as the economy shrinks—the so-called automatic stabiliser would thus still be able to work). For the cyclical part of the deficits, the European benchmarks of the Stability and Growth Pact apply. But in addition to the rather soft recommendations implied by the pact, the German debt brake implements a rules-based automatic feedback of cyclical deficits and surpluses. Both have to be booked on an ‘adjustment account’ that over the business cycle should be balanced at zero. Hence, in good times government is obliged to pay into the account; in bad times it is allowed to draw from it. ‘Good times’ and ‘bad times’ are defined as deviations of current economic growth from the long-term growth path or as cyclical variations of the production gap.

Further exemptions from the balanced budget obligations can be made (with the explicit consent of both chambers) in the case of natural disasters or unusual emergencies (the present recession would be a case in point). For five German states that are most heavily in debt, the federal government and the other states promise to provide financial support (a total €7.2 billion) in order to facilitate the efforts of these states to consolidate their budgets.

Whether the German debt brake will prove to be efficient remains to be seen. From an economic point of view it could be expected that the German model will help to safeguard or, rather, create fiscal sustainability, while at the same time allowing the automatic stabilisers fully to play. From a political economic perspective, the mere implementation of the debt brake can already be seen as a success in overcoming the short-term incentives of political actors. This unlikely event—the creation of credible commitments to abandon the vote-winning strategy of spending without taxing—was made possible by a combination of (a) lagged implementation and transitional adjustment, (b) multi-partisanship and (c) a constitutional commitment.

Conclusions and Policy Recommendations

- The present severe economic crisis will lead to heavy, in many cases unprecedented, public deficits in most EU Member States. A reduction of current public deficits and of accumulated public debt is unlikely to happen even for years after the end of the present crisis—if no drastic consolidation efforts are undertaken. This is because (a) public debt had in many cases reached unsustainable levels long before the crisis and (b) there has been almost no fiscal pre-positioning for the long-term obligations that by far exceed the budgetary consequences of the crisis: the demographic shock that will strike most EU Member States.
- Even if there were no demographic decline in the number of future taxpayers facing an increased number of

transfer recipients, public debt would create a burden for future generations. A large part of the accumulated public deficits were devoted to consumption, which did not increase public capital from which future generations could benefit. In various ways, public deficit-spending crowds out private investment and thus reduces capital formation and real income opportunities in the future.

- Defaulting on or inflating away public debt may be a tempting way out of debt, but it is neither morally acceptable nor politically sustainable.

- Hence, a long-term strategy for escaping the debt-trap is needed. Such a strategy involves short-term pain in order to avoid long-term economic decline. However, there are feasible proposals and empirical examples of a successful return to stability.

- For most EU Member States, higher taxes should not be a sustainable path to consolidation, since their governments are already quite near to over-taxing citizens, which means that higher taxes could lead to lower growth and thus higher debt-to-GDP ratios in the longer run.

- Lower public expenditures would more reliably reduce the fiscal burden and might even boost growth by ‘crowding in’ private investment. Shifting public outlays from consumptive spending (e.g., on welfare, defence and redistribution) to public investment (e.g., in education and research) could have the most beneficial consequences for future generations.

- Boosting economic growth is the best way to overcome even constant or less rapidly growing absolute levels of

public debt. By letting competitive market forces create innovation and growth, the debt trap can most comfortably be avoided. Growth-enhancing structural reforms, such as deregulation of labour markets or a further opening of European markets for services, would contribute to both economic growth and fiscal consolidation.

- Reforms of social security systems are urgently needed in most EU countries in order to address the unavoidable demographic shock that will burden future budgets and future generations much more than will the present crisis. Thus, strategies for health care and pension reform should be prioritised. Increasing the effective retirement age, supporting private capital formation or updating the rent formula may be needed in many parts of Europe. Similar adjustments of current entitlement-to-burden ratios might be needed for health care.

- All the above-mentioned recommendations may be asking too much of ordinary politics—the interaction between current voters and beneficiaries and political parties in the permanent struggles for votes. There are several institutional ways of political pre-commitment that should help EU Member States to escape the debt trap in a sustainable way, such as granting parents additional votes for their children, demanding super-majorities in parliament for debt-financed outlays, or enacting time-lagged balanced-budget requirements on a constitutional level.

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