STIFTUNG Marktwirtschaft

Honorable States?
An Examination of True Public Debt in Europe
True German Government Debt Approaching €5 Trillion[*]

The European debt crisis has not merely rattled banks and financial markets; the menacing shock-waves of imminent state bankruptcy have adversely affected the real economy, brought Europe to the brink of another deep recession, and have placed jobs at risk. Moreover, many people fear for their savings as the prospect of the use of inflation as an escape from the sovereign debt crisis looms in their minds. In the midst of such uncertainty, we must ascertain the real state of public finances in the Euro-zone.

1. The Inability of the Maastricht Criteria to Adequately Contain Public Debt

Discussion of public debt generally concerns either the current budget deficit, which must be covered by additional borrowing, or the sum of previously accumulated debt. The Maastricht criteria and the European Stability and Growth Pact reflect this traditional interpretation of public debt. This framework intended to ensure that all member countries in the Eurozone maintain sound public finances and to institute a "no bailout rule," by which no country would come to depend upon another for fiscal rescue. For these purposes, European law established the following two debt limits:

- annual budget deficits must not exceed 3% of the gross domestic product (GDP) (*deficit criterion*)
- outstanding debt must not exceed 60% of GDP *(debt criterion)*.

As the current crisis has demonstrated, the Maastricht criteria have failed to achieve the goal of stable public finances. Both the tendency of states to incur debt and the lack of political compulsion attached to the criteria have contributed to this failure.

2. Public Debt Honestly Calculated – the Future Is Important

Even more problematic is the fact that the official debt statistics comprise only a (small) piece of total public liabilities. The reason is simple: only the current budget deficit and debts incurred in the past are calculated.

Include Future Liabilities

Conventional statistics ignore that, in addition to its conventional expenditures, **states regularly acquire legally-binding future liabilities without setting aside the appropriate fiscal reserves**. These liabilities will necessitate substantial increases in government spending in future years for programs like old-age pensions, health care and long-term care. The hope that revenue from taxation and mandatory social security contributions will automatically increase along with public expenditures, thereby ensuring the fiscal sustainability of such programs, is unrealistic at a time when populations across Europe continue to mature.

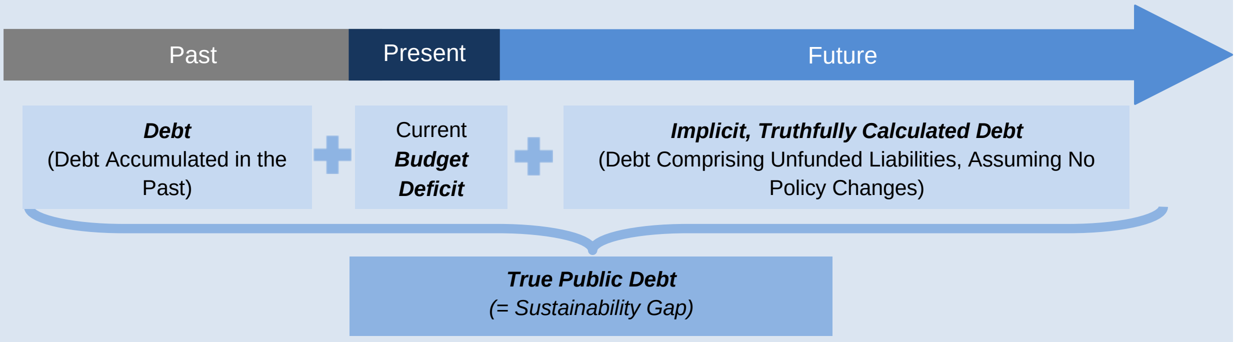
Incorporate Demography

On the one hand, **demographic ageing** in the coming decades will considerably raise all public expenditures for services and entitlements for the elderly, such as publically-funded old-age pensions, health insurance and long-term care insurance schemes. On the other hand, the proportion of the population that is working-aged – the people who finance the vast majority of social insurance contributions and income taxes – will simultaneously fall. Both of these demographic trends ensure that public expenditures will far outrun public receipts, provided that the state abstains from reforms and maintains the status quo. These future debts are the direct result of political decisions made by the policymakers of today (and yesterday).

Therefore, a realistic view of true public debt must add the implicit debt of the future to the visible, explicit debt of the past. Together, these comprise the sustainability gap.

[*] In this document, the term „billion" means 10^9, i.e. one thousand million.

True Public Debt



3. How high is the true public debt?

The Stiftung Marktwirtschaft (Market Economy Foundation) and the Forschungszentrum Generationenverträge (Research Center for Generational Contracts) regularly calculate the level of true public debt. The following table displays the results, which incorporate data from the current economic situation (autumn 2011), for Germany and the other members of the EU-15. For the great majority of countries studied, implicit debt comprises the lion's share of total public debt. **The traditional analysis of public debt, which conforms with the Maastricht criteria, conveys a view of the fiscal situation that is unfortunately all too optimistic.**

International Comparison of State Debt – Sustainability Ranking (baseyear 2010)

		Explicit State Debt	Implicit State Debt	Sustainability Gap	Necessary Consolidation
1	Sweden	42,2	-84,5	**-42,3**	-0,5
2	Denmark	43,4	28,6	**71,9**	1,1
3	Italy	118,4	27,6	**146,0**	2,4
4	Germany	83,2	109,4	**192,6**	4,0
5	Finland	48,3	146,9	**195,2**	2,7
6	Austria	71,8	225,9	**297,7**	4,8
7	France	82,3	255,2	**337,5**	4,3
8	Portugal	93,3	265,5	**358,8**	6,5
9	Belgium	96,2	329,8	**426,0**	5,3
10	Netherlands	62,9	431,8	**494,6**	8,1
11	Spain	61,0	487,5	**548,5**	7,0
12	United Kingdom	79,6	812,1	**891,7**	9,7
13	Greece	144,9	872,0	**1016,9**	17,6
14	Luxembourg	19,1	1096,5	**1115,6**	12,0
15	Ireland	92,5	1404,7	**1497,2**	10,4

Source: European Commission, AMECO Database, Eurostat, Calculations: Forschungszentrum Generationenverträge.

The "Fiscal Gap" corresponds to the reduction in government expenditures (in percent of GDP) or, alternatively, the increase in government revenue (in percent of GDP) necessary to put public finances back on a sustainable path. **For Germany**, the **4.0 percent of GDP corresponds to approximately €100 billion annually**.

Our Propositions:

Of highest priority is transparency and a credible consolidation policy in all countries. This requires

1. *an effective limit to budget deficits and*
2. *future government expenditures and revenues to be brought into line. Reforms are particularly necessary in social security systems and in public sector pension plans, as these are the main sources of true public debt.*