# Shall we borrow from the children

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essay: Shall We Borrow from the Children?, essay In most places around the world, it is still usual that parents look after their small children and grown children look after their elderly parents. The looking after is unpaid work and is not counted in the national product. Sweden has passed that stage. In Sweden, the lookers-after look after other peoples small children and elderly parents, while their own small children and their own elderly parents are looked after by yet other people. The state pays everybody for the looking after. The total of this pay is added to the national product. It also gets added to the budget deficit unless taxes have meanwhile been increased.

It is a commonplace that Sweden runs what is probably the worlds most extensive welfare state, and suffers from the absurdities that welfare states usually generate. It is tempting to blame the obtuseness of the electorate for voting with absolute consistency, in election after election, for the extension or at worst the maintenance of the welfare system and a sharp egalitarian bias in tax policy at the cost” a cost most do not recognise” of reduced material wealth. It is arguable that with its high level of education, exemplary civility and admirable technological leadership in many fields, Sweden should be much richer than it is. Nevertheless, it is also true (though less of a commonplace) that if they really must have a welfare state, the Swedes manage it less wastefully and more intelligently than most. Since the reforms put in place over the last few years, the countrys overall economic performance has improved markedly. Moreover, while until the late 1990s Swedens “ social” spending as a share of national income was the highest in Europe, this share has since been reined back a little and is now exceeded by that of France whose welfare system is not quite as comprehensive, but is

more wasteful. Sensible Sweden has now taken a sensible decision; in a referendum on 14 September, it has by a majority of 56 per cent rejected the proposal to adopt the Euro as its currency.

Two things are remarkable about this outcome. One is that government and opposition, large corporations, the media and all the chattering and scribbling classes have joined forces in a sometimes quite frantic campaign for a " yes" vote. Outlandish claims were made about how the Euro will speed up economic growth and reduce the cost of living," the exact opposite of what has happened in the Euro-zone since its formation. The electorate has remained deaf to these extravagantly un-Swedish promises. Nor did dire threats of being " shut out of Europe" impress it.

The other remarkable feature of the referendum was that according to the pollsters, the chief reason for rejecting the common currency was the fear that as a member of the Euro-zone, Sweden would be obliged to curtail its welfare system" a misperceived threat if ever there was one. However, the upshot is that Sweden is staying out, Denmark is less and less likely to reverse its earlier rejection of the common currency, while the present British governments ambition to persuade the country to adopt it looks for the time being utterly hopeless. Maybe the Euro is rejected for all the wrong reasons, but the choice is probably right: the Euro is a trap.

It is an unintended one, but no less cunning for that. Each member state of the Euro-zone is caught between two alternatives: to engage in fiscal free-riding or to be the sucker, the victim of free riding by the others. The reason is easy to grasp. When a country has its own currency, fiscal profligacy

carries its own punishment. Interest on the national debt rises more than proportionately to the debt, both because the countrys own capital market gets overstretched, and because the risk attaching to its currency increases. Default on the debt and devaluation of the currency (coming after a flight into inflation to water down the debt), though perhaps still remote, start looking less improbable. The repercussions render a loose fiscal posture more and more difficult to hold, and in due course tend to impose some discipline on the government.

As a member of the Euro-zone, the same government running a large deficit is spared most of these disciplinary consequences. No member country, with the possible exception of Germany, is big enough in the zone as a whole, for its deficit financing to represent a significant strain on the zones capital market. Currency risk subsists only relative to currencies outside the zone, in practice only the dollar and the yen, but it is eliminated within the zone; there is no Greek Euro and no Spanish Euro, so one cannot weaken relative to the other. Fiscal irresponsibility by one country still has adverse consequences for the zone as a whole, but only a small fraction of them is borne by the irresponsible country in question, with the bulk spread over all the other member countries. This is the classic breeding ground for free riding. Under these circumstances, fiscal vice is not punished but fiscal virtue is. Today, Spain maintains a balanced budget, while both Germany and France are running deficits that hover around the mark of 4 per cent of GDP.

According to all serious forecasts, their deficits will exceed 3 per cent of GDP for four years or more in a row, not dipping below that level before 2066 at the earliest. One result is that Spanish borrowers have to pay higher medium

and long rates of interest than they would do if Germany and France also had balanced budgets. This is not to say that budget deficits are always evil if some of their negative consequences are shifted to other countries, as they in fact are in the Euro-zone. In the short run, occasional deficits may be justified" or would be if they were not habit-forming.

However, it is clear that in a Euro-zone-type arrangement, defence against the free riding of others consists in becoming a free rider oneself. Where the markets do not automatically provide deterrents to overspending, can " constitutional" rules do so? Germany, with its strong anti-inflationary, sound-money leanings has tried to inject such rules into the Euro-zone when it got its partners to adopt the so called " growth and stability pact", as part of the Maastricht treaty. The rule sets an upper limit of 60 per cent of GDP on the national debt and 3 per cent of GDP on the annual budget deficit of Euro-zone countries. The debt limit has no " teeth"; in fact, the average share of the national debts of the Euro-zone countries is now 71. 5 per cent of their GDP, with Italy and Belgium the chief offenders with over 100 per cent and both France and Germany now over 60 per cent and rising.

The deficit limit has " teeth" but very weak ones. The offending country is summoned to take remedial measures, and if it fails to bring its deficit down to the limit, it may be fined. However, few observers seriously believe that the Brussels Commission would dare to fine an influential member country, nor that the fine, if by miracle it were imposed, would change that countrys fiscal policy. To make doubly sure, a strong movement is now afoot to take the " rigidity" out of the pact.

If the pact is not kept when it is not convenient to keep it, what remedy can the Euro-zone find against fiscal free riding that looks capable of undermining the Euro? In the United States, the vast bulk of public spending is decided in Washington at the federal level. The states might have an incentive to free-ride, but have little or no scope to do so. In Europe the central budget is only about 2. 5 per cent of the member states combined GDP, and each member state has both incentive and scope to free-ride at the expense of the rest. The conclusion is obvious: to throttle back fiscal free riding by the member states and protect the Euro, taxing and spending decisions have gradually to move from the states to Brussels. Whatever it may be called, in practice it means a move towards a move towards a more politically centralized Europe" a move the new European constitution, now in the final negotiating phase, would surreptitiously facilitate. ;,?