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ARTICLES

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a good reason not to worry about public debt

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LOOKING, WITHOUT SUCCESS, FOR A GOOD REASON NOT TO WORRY ABOUT PUBLIC DEBT

Pierre Garelo / Vesselina Spassova*

1. The many facets of the relationship between growth and public debt

Few will debate the proposition that the rate at which an economy grows has an impact on its debt and that, inversely, public debt impacts growth. Opinions among economists however start to diverge when dealing with the magnitude and direction of such impacts. To decide these questions macroeconomic modelling and econometrics have often been relied upon. Here, however, another path has been taken to approach the study of the interactions between national debt and economic growth.

Drawing a parallel with the case of a household economy, we believe—admittedly without great originality—that, depending on how the borrowed capital is used, public debt can lead to greater or lesser public wealth. For this reason we have decided to look first at *the structure of public spending*: what are the respective shares of consumption and investment expenditure? We will see that, in a country such as France, most public money is spent on

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consumption and little on investment, so that sound reasons exist for concern about an increasing public debt.

Of course, some have argued—and still argue—that the structure of spending does not matter and that *any* form of spending generates growth. Were this kind of naïve Keynesian approach correct, and should one maintain—as one should—that growth can hardly exist without investment, then public spending *must* lead to a higher rate of investment, whether private or public. To test the plausibility of this scenario—where public spending boosts private investment which in turn generates growth—one must look at the impact of public spending on private investment. The data we provide below on this relationship clearly show, at least in the case of France, the existence of a crowding out effect: increased public spending has run parallel with *reduced* public investment *and* reduced private investment.

Returning to the household metaphor, and leaving aside for a moment the structure of public spending, another way of approaching the relationship between debt and growth is to bring the level of taxation into the picture. Indeed, just as a household can choose to leave its consumption unchanged and finance its current investment with debt, it can be the case that governments choose to finance current investment with debt rather than taxes, with the intention of repaying the debt subsequent to the anticipated growth to be generated by this investment. Tomorrow's growth and employment, say such governments, will pay for the debt and there will be no need to increase taxes further. This is also, in part, the logic behind the automatic stabilizer mechanism. Now, if this scenario were to bear some relation to economic reality, then countries with high debt would also tend to be countries with low taxes. But, as will be shown below, the opposite is true: countries with high debt are also countries with high levels of taxation.

Hence if higher debt is the consequence neither of increased investment, nor of the desire to keep taxes low, how can we explain the rapid increase in the debt-to-GDP ratio which actually occurred in many countries in the 80s, and 90s, and is still an ongoing process in countries such as France? Obviously, increased

public consumption is likely to be the main cause, and we will return to this at the end of the study. Another partial, but essential, explanation lies in the developments which took place in the monetary and financial markets during that period. In the mid-80s there occurred a shift from a high to a low inflationary environment. Hence, where borrowing continued to be the operative strategy for government¹, its cost, as reflected in the level of the debt to GDP ratio, is rapidly increasing.

A third explanation to the debt explosion can be found in the fact that the “political cost” of financing public spending with debt is *lower* than the political cost associated with the financing of public spending *via* a tax increase. There seems to be strong evidence that the so-called Ricardian equivalence does not hold in the eyes of the tax-payer: a deficit is less painful than a tax increase, even though it means more taxes tomorrow. This strangely myopic behaviour on the part of the tax-payer in turn allows governments to continue to rely more heavily on deficits to increase their spending, at the expense of higher debt.

To sum up, the pieces of evidence gathered in the study seem to converge towards a single conclusion: the currently high levels of public debt prevailing in most developed countries are likely *to lower* the growth rate of those countries in the coming years. Also, and again due to the structure of public spending, a lower rate of growth of GDP will most probably lead to even further increases in public spending. We accordingly conclude this study with an urgent recommendation to those economies *to reconsider the structure of their public spending*. Such a policy change, though undoubtedly difficult to implement, constitutes the only way out of the harmful dynamics where lower growth translates into future higher deficits and higher debt tomorrow, which in turn entail lower growth and increased deficits the day after tomorrow, and so on. Meanwhile, an increase in the tax burden with the hope of reducing the relative level of debt does not constitute a viable alternative policy. Instead, the study confirms previous findings that *a lower tax burden fosters growth and thus provides the*

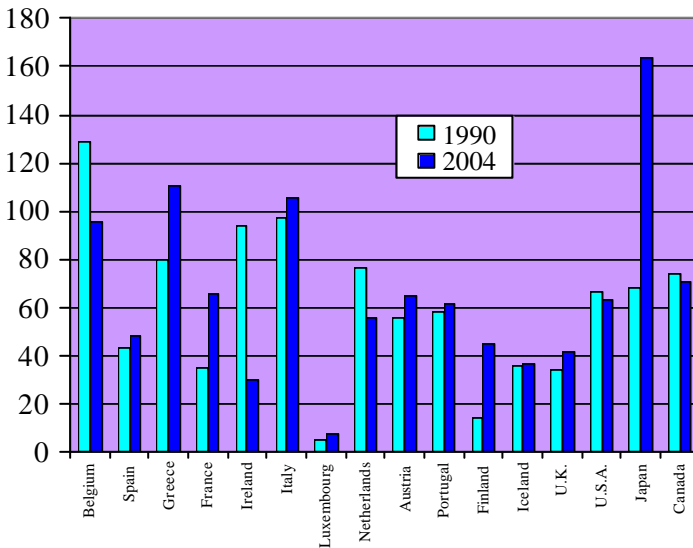
¹ And, strangely, an increasingly tempting strategy due to the globalization of the financial market.

economy with a truly efficient tool to reduce debt to a sustainable level.

2. Public debt and the structure of public expenditure: the case of France

As indicated by the data (Figure 1), the public debt of most developed economies has passed the threshold of 40% of GDP and though in some countries a peak seems to have been reached in the mid 90s, many have as yet been unable so far to reverse the trend (Figure 2).

Figure 1. Evolution of Public Debt as percentage of GDP (Source : yearbook OECD)



If we look at the case of France (Figure 3), the trend is particularly worrying: over the last quarter century, public debt in volume multiplied by a factor of more than 10 (from €73,8 billion to €992 billion) and as a percentage of GDP by a factor of 3 (from 21,3 to 63,7%).

To better appreciate what those figures mean, it might be useful to compare the amount of the debt, not to the GDP level—i.e., to an evaluation of the wealth created by the whole population during that period—but to the government revenues (tax revenues) for a given year. It appears then that, since 1993, French public debt represents more than one year of tax revenues (Figure 4).²

Having pointed out that public debt has reached a sizable amount of money, we wish now to study in greater detail *the composition of the public expenditure* made possible through that borrowing. Again, we will, for now, limit ourselves to the case of France for which data were more readily available. Let us reiterate that, in an optimistic scenario, public debt could be a growth factor to the extent that it allows a relative increase in public and/or private investment.

Figure 5 gives us the structure of French public spending based on the State budget voted for by the French Parliament for the year 2005 (data on interest charges are taken from INSEE).

² Another interesting set of data is yielded when public deficit and tax revenues are compared for the corresponding year. One finds that the deficit represents in some years more than 25% of tax revenues! It is well known, at least since the work of the Nobel Prize winners Daniel Kahneman and Amos Tversky, that every decision maker is subject to “framing effects”. That is to say, her choice varies according to the way the parameters of the problem are presented to her. Should one wish—as we do—to make citizens aware of the problem generated by the increasing public debt, it might be advisable to compare public debt to tax revenues instead of GDP. To further illustrate this point, if you said that the deficit of the social security system was €12 billion for the year 2005 this would not mean much to the layman. But if you told the same people that the deficit represented 400,000 jobs for one year, at €30,000 a year, they would be more likely to pay greater attention to what you had to say about the significance of the social security deficit.

To fit all public expenditure into such a typology is of course not easy. If some spending (such as the interest charges on debt) is easily identifiable and classifiable, others (such as state education expenditure) could be classified as either investment or operating costs. Our choice here has been to follow as closely as we can the same terminology used in the document presented to Parliament.³ Here is, at a glance, what one can find in each category:

1. labour costs: this category includes wages and associated benefits for state employees (including the military) as well as pension benefits for civil servants.
2. transfer payments: social allowances (for example, social security, social aid for the handicapped), employment and housing aid, subsidies for territorial districts etc.
3. investment: this category of expenditure is relative to civil and military investment.
4. operating costs: all material expenditures, such as various purchases, real estate, property and vehicle maintenance, etc.

For the purpose of this study on debt and growth one fact needs to be emphasized, namely, that only a small share of public expenditure goes to investment, the rest going either to pay the interest on the debt, to operating costs, or to so-called social and economic transfers. We will come back to the cost of the debt in the next section. As for the last two categories, the first is difficult to reduce in a short period of time (for instance, the number of public employees and the payment of pensions to civil servants which together represent x% of the budget of the state in 2004). The second—the share represented by social and economic transfers—is likely *to increase* whenever growth is slowing. Surely, one cannot say *a priori* that spending, say, 8% of the budget on investment will be sufficient to generate growth and therefore lead to an “automatic” reduction of the level of transfers

³ Another study available at www.viepublique.com reaches a similar conclusion: Following their calculation the French government Budget for 2002 consisted of 13.9% for interest charges, 54.5% for labour, operating costs and transfers relating to public administration, and 31.6% for other transfers and subsidies.

in the near future. But if 8% is insufficient, or if, for any other reason (such as a decrease in *private* investment), growth does not occur, then it is most likely that the share of transfers will increase, entailing a probable decrease of public investment in real terms.

Figure 2: Evolution of Public Debt as % of GDP in the 90s (Source: Eurostat and IREF)

	1992	1993	1994	1995	1996
EU (25)	:	:	:	:	:
EU (15)	:	:	66.4 (r)	70.8 (r)	72.6 (r)
Euro zone	60.0	65.6	68.3	73.1	74.6
Belgium	132.2	137.9	135.9	134.0	130.2
Czech Rep.	:	:	:	:	:
Danmark	69.4 (r)	81.1 (r)	77.4 (r)	73.2 (r)	69.7 (r)
Germany	42.9	46.9	49.3	57.0	59.8
Estonia	:	:	:	:	:
Greece	87.8	110.1	107.9	108.7	111.3
Spain	46.8	58.4	61.1	63.9	68.1
France	39.6	45.3	48.4	54.6	57.1
Ireland	92.5	95.1	89.6	81.8	73.3
Italy	108.1	118.7	124.8	124.3	123.1
Cyprus	:	:	:	:	:
Latonia	:	:	:	:	:
Lithuania	:	:	:	:	:
Luxembourg	5.5	6.8	6.3	6.7	7.2

(N.B.: For each country the highest value has been underscored)

1997	1998	1999	2000	2001	2002	2003
:	67.5 (r)	66.7 (r)	62.9 (r)	62.1 (r)	61.6 (r)	63.3 (r)
71.0 (r)	68.9 (r)	67.9 (r)	64.1 (r)	63.3 (r)	62.7 (r)	64.3 (r)
74.3	73.6 (r)	72.1 (r)	69.6 (r)	69.5 (r)	69.4	70.7
124.8	119.6	114.8	109.1 (r)	108.1 (r)	105.8 (r)	100.7 (r)
12.2	12.9	13.4	18.2 (r)	25.3 (r)	28.8 (r)	37.8 (r)
65.7 (r)	61.2 (r)	57.7 (r)	52.3 (r)	49.2 (r)	48.8 (r)	45.9 (r)
61.0	60.9	61.2	60.2	59.4 (r)	60.9 (r)	64.2 (r)
6.4	5.6	6.0	4.7	4.4	5.3	5.3
108.2	105.8	105.2	114.0 (r)	114.7 (r)	112.5 (r)	109.9 (r)
66.6	64.6	63.1	61.1 (r)	57.5 (r)	54.4 (r)	50.7 (r)
59.3	59.5	58.5	56.8 (r)	56.5 (r)	58.8	63.7
64.5	53.8	48.6	38.3 (r)	35.9 (r)	32.7 (r)	32.1 (r)
120.5	116.7	115.5	111.2 (r)	110.6 (r)	107.9 (r)	106.2 (r)
:	61.6	62.0	61.6 (r)	64.3 (r)	67.4 (r)	70.9 (r)
:	9.8	12.6	12.9	14.9	14.1	14.4
15.2	16.5	23.0	23.8	22.9	22.4	21.6 (r)
6.8	6.3	5.9	5.5 (r)	5.5 (r)	5.7 (r)	5.4 (r)

	1992	1993	1994	1995	1996
Hungary	:	:	:	:	:
Malta	:	:	:	:	:
Netherlands	77.9	79.3	76.4	77.2	75.2
Austria	55.8	60.5	63.4	67.9	67.6
Poland	:	:	:	:	:
Portugal	54.4	59.1	62.1	64.3	62.9
Slovenia	:	:	:	:	:
Slovakia	:	:	:	:	30.6
Finland	40.5	55.9	58.0	57.1	57.1
Sweden	:	:	73.9	73.7 (r)	73.5
U.K.	39.2	45.4	48.6	51.8	52.3
Bulgaria	:	:	:	:	:
Croatia	:	:	:	:	:
Romania	:	:	:	:	:
Turkey	:	:	:	:	:
Iceland	46.3	53.2	55.8	59.2	56.6
Norway	:	:	:	:	:
USA	73.7	75.4	74.6	74.2	73.4
Japan	68.7	74.9	79.7	87.1	93.9
Canada	89.9	96.9	98.2	100.8	100.3

Garello / Spassova: Worry about public debt

1997	1998	1999	2000	2001	2002	2003
64.2	61.9	61.2	55.4	53.5	57.2	59.1
51.5	64.9	56.8	56.4 (r)	62.2 (r)	62.7 (r)	71.1 (r)
69.9	66.8	63.1	55.9	52.9 (r)	52.6 (r)	54.1 (r)
63.8	64.2 (r)	66.5 (r)	67.0 (r)	67.1 (r)	66.6 (r)	65.1 (r)
44.0	39.1	40.3	36.8	36.7	41.1	45.4
59.1	55.0	54.3	53.3	55.8 (r)	58.4 (r)	60.3 (r)
:	23.6	24.9	27.4	28.1	29.5	29.5
33.1	34.0	47.2	49.9	48.7	43.3	42.6
54.1	48.6	47.0	44.6 (r)	43.8 (r)	42.6 (r)	45.6 (r)
70.6	68.1 (r)	62.7 (r)	52.8	54.4	52.6	52.0 (r)
50.8	47.7	45.1	42.0 (r)	38.8 (r)	38.3 (r)	39.8 (r)
105.1	79.6	79.3	73.6	66.2	53.2	46.2
:	:	:	:	:	:	:
16.5	18.0	24.0	23.9	23.2	23.3	21.8
52.7	50.2	67.4	57.4	105.2	94.3	87.4
54.4	49.3	44.6	42.0	46.6	44.1	41.3
27.5	26.2	26.8	30.0	29.2	35.7	42.0
70.9	67.9	64.5	58.8	58.4	60.5	62.7
100.3	112.2	125.7	134.1	142.3	149.4	157.6
96.2	93.9	89.5	82.0	81.0	77.8	75.6

Figure 3: Evolution of the French Public Debt
(Source: INSEE – Les Comptes de la Nation)

	1978	1980	1982	1984	1986	1988
In billions of euros						
State	44,4	54,5	93,6	131,8	168,2	209,1
Various unities of central administration	1,0	1,2	1,8	2,5	3,8	1,2
Local administrations	23,9	30,2	41,1	53,7	65,9	78,1
Social security administration	3,5	4,9	6,0	9,0	5,4	7,1
Total for public administration	72,8	90,8	142,6	197,0	243,4	295,5
In % of GDP						
State	13,0	12,4	16,6	19,4	21,5	23,5
Various unities of central administration	0,3	0,3	0,3	0,4	0,5	0,1
Local administrations	7,0	6,9	7,3	7,9	8,4	8,8
Social security administration	1,0	1,1	1,1	1,3	0,7	0,8
Total for public administration	21,3	20,7	25,2	29,0	31,1	33,2

Garello / Spassova: Worry about public debt

1990	1992	1994	1996	1998	2000	2003
259,8	316,5	425,8	515,0	600,7	642,2	799,
1,7	1,8	4,6	51,0	56,1	51,7	56,3
85,8	94,6	102,6	106,6	106,7	105,7	105,
7,4	16,9	20,0	19,2	13,7	12,5	31,4
354,7	429,7	553,0	691,8	777,3	812,1	992
25,7	29,1	37,2	42,5	46,0	45,2	51,3
0,2	0,2	0,4	4,2	4,3	3,6	3,6
8,5	8,7	9,0	8,8	8,2	7,4	6,8
0,7	1,6	1,7	1,6	1,1	0,9	2,0
35,1	39,6	48,4	57,1	59,5	57,2	63,7

**Figure 4: French public debt
as percentage of tax receipt
(Source: INSEE, Comptes de la Nation)**

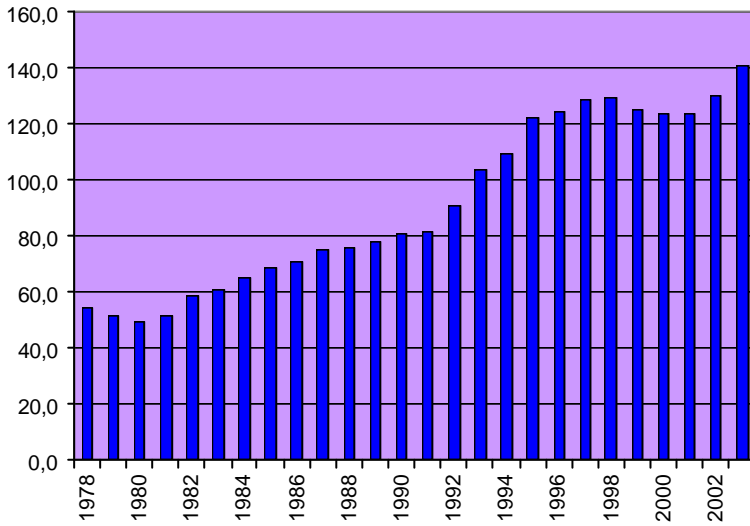
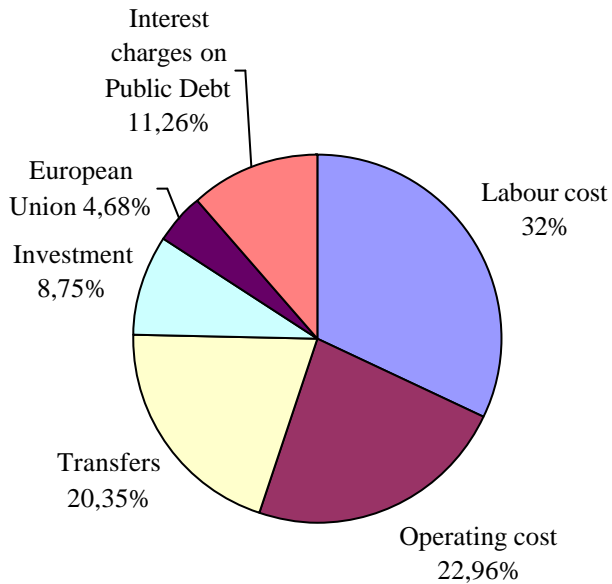


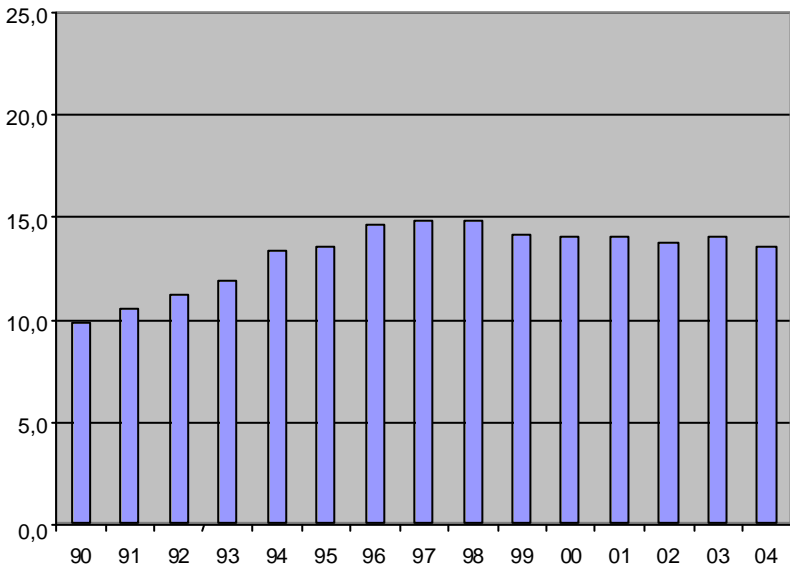
Figure 5: The Nature of Public Spending (France, Budget 2005) (Source: Own calculation based on loi des finances 2005 and INSEE)



3. The increasing cost of debt

As we can see on the chart below, for France, the debt interest charges have been increasing almost continuously since the early 1980s to reach 2.34% of GDP or 10.9% of total public expenditure and 14.35% of fiscal revenue by 2004.

Figure 6: Interest Charges on Public Debt as % of Total Government Expenditures (Source: Minister of Finance, Economy and Industry)



This evolution is partly due to the growth of the public deficit, and partly due to changes in the conditions under which the state is able to finance its budget deficit. To be more precise, whenever

there is a gap between the interest rate (henceforth denoted i) and the rate of growth of GDP (g), i.e., whenever $i > g$, the government must realize a budgetary surplus to maintain the ratio of public debt to GDP at a constant level. If it does not, a snowball effect will appear, each new deficit (or insufficiently positive balance) leading to an increase in the debt/GDP ratio.

This dynamic can best be understood with some simple algebra. If B_t is the balance of the public budget at time t and D_t the level of public debt at time t , the primary balance (i.e., the general government balance plus interest charges) is $BP_t = B_t + iD_t$. The relation between the levels of debt for two successive periods is therefore given by: $D_{t+1} = (1+i) D_t - BP_{t+1}$. The debt at time $t+1$ is the debt at time t , plus interest charges on that debt, minus the credit balance (or plus the current primary deficit if BP_{t+1} is negative). To maintain the ratio debt/GDP as a constant means that $D_{t+1}/Y_{t+1} = D_t/Y_t$, where Y_t is GDP at time t . Letting g denote GDP's growth (i.e., $g = (Y_{t+1} - Y_t)/Y_t$), we obtain the following:

$$\frac{D_{t+1}}{Y_{t+1}} = \frac{1+i}{1+g} \frac{D_t}{Y_t} - \frac{BP_{t+1}}{Y_{t+1}}$$

If we now impose $D_{t+1}/Y_{t+1} = D_t/Y_t$ this leads to the following condition if the Debt/GDP ratio is to be held constant:

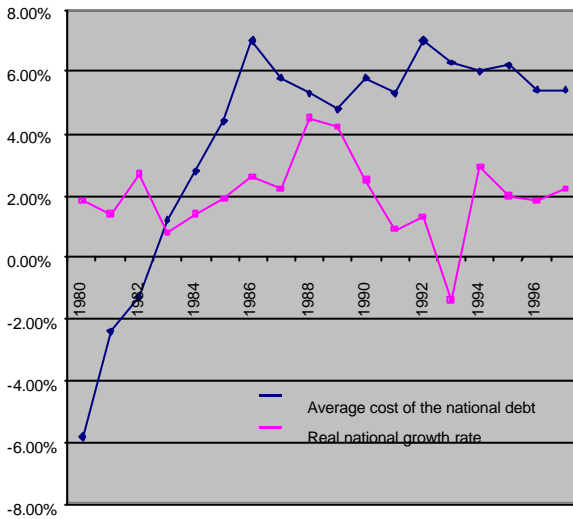
$$\frac{BP_{t+1}}{Y_{t+1}} = \left[\frac{i-g}{1+g} \right] \frac{D_t}{Y_t}.$$

Hence, if $i > g$ the government must have a positive primary balance in order to maintain the debt-to-GDP ratio and avoid the snowball effect. If, on the contrary, the state can finance its debt at an advantageous rate such that $i < g$, then the government can afford some primary budget deficit without having to face an explosion of public debt.

If we look at the long term progression of *real* interest rates and the rate of GDP growth in *real* terms, we see clearly that one of the reasons for the debt explosion which started in the 80s lies in the relentless increase of the gap between i and g . Until 1982 we

were (in France) in a situation where $i < g$ and it was relatively easy to control the debt ratio. Since 1982, the configuration has reversed; $i > g$ so that only an extremely thrifty economy can control the debt ratio.

Figure 7: Evolution of real interest rate and real growth (1980-1997) (Source: Comptes Nationaux (National Accounts), base 1980)



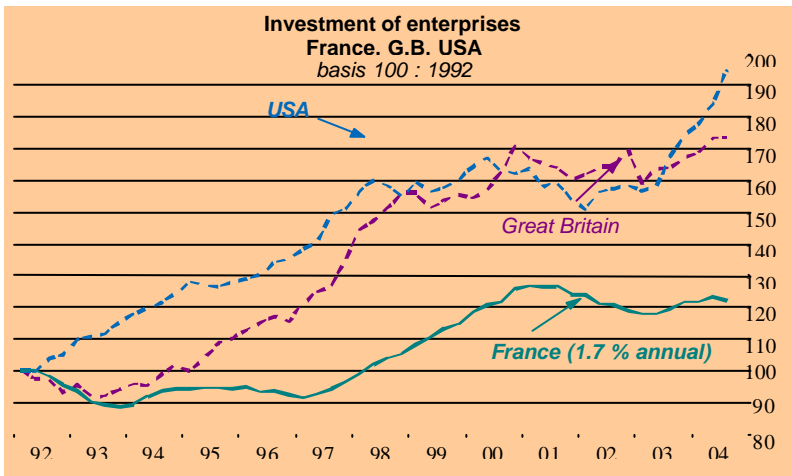
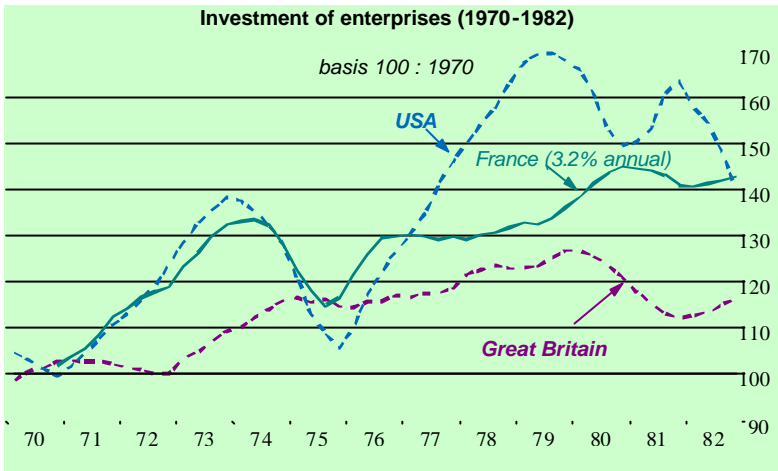
Putting together this result with the result of the previous section, an obvious corollary is that the state cannot maintain present existing levels of public spending once the inflationary times are over. Or, to put it somewhat more mildly, the risk exposure to an increase in the rate of interest for a state with high public debt should worry every responsible person.

4. Public debt crowding out private investment

At this point in our inquiry we have now gained a better understanding of what the structure of public spending has been for the previous years: little investment, high social and economic transfers coupled with high operating costs to which the mounting costs of debt must be added. Still, as indicated above, this could well be compatible with healthy growth if the level of *private* investment was increasing. However, taking the case of France again, we find strong evidence that this has not been the case. As a matter of fact, while public spending and public debt were increasing, the rate of investment in France was falling.

In the 70s and early 80s, private investment increased in France at an annual rate of 3.2%, equal to that of the US and outperforming the UK (Figure 8). In the 90s, however, the US and the UK started to decrease their level of debt (for those two countries, the ratio debt/GDP started to decrease respectively in 1993 and 1996) and private investment in those countries grew at a fairly high rate. Meanwhile, in France, for the same period, that rate fell at 1.7% (Figure 9). Everything seems to indicate therefore that a crowding out effect is at work.

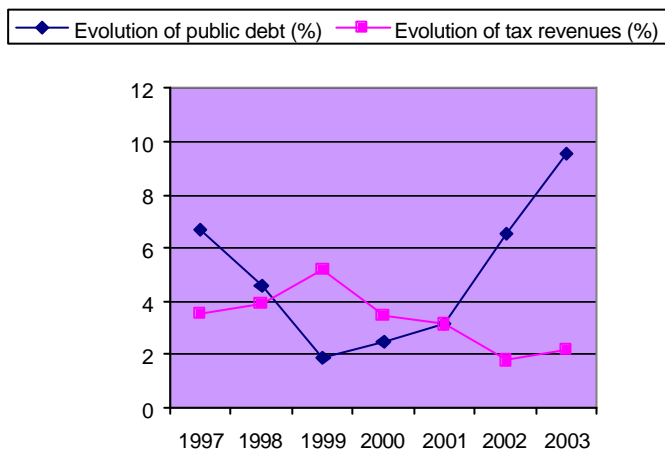
Figures 8 and 9: Evolution of private investment during the 70s and 90s (Source; Les Cahiers Verts de l'Economie, Socofi)



5. Debt, taxes and growth

At first glance, the figures for public debt and tax receipts indicate that in many countries debt increased more rapidly than tax receipts. Figure 10 gives us the recent rates of growth of public debt and tax receipts for France. This evolution could well be a consequence of a deliberate strategy on the part of the government; a strategy that would consist of maintaining tax pressure at a *low* level in order to promote investment, even while, in the short run, the price to be paid for such a strategy is a higher deficit and increasing debt.

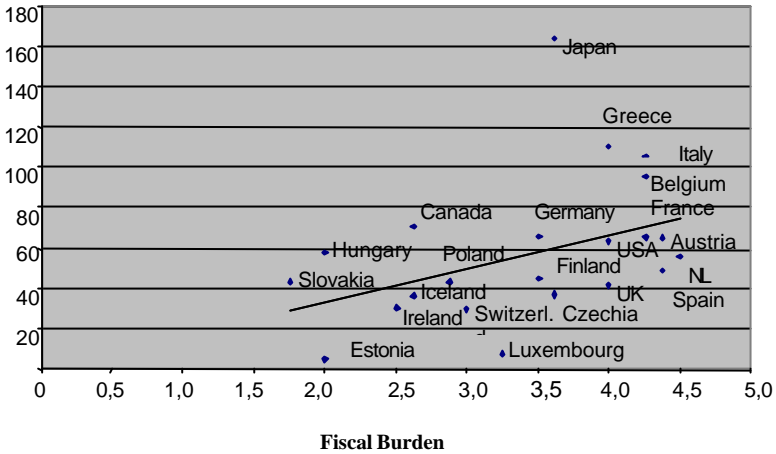
Figure 10: Evolution of Public Debt and Tax revenues in France: 1997-2003 (Source: IREF based on data from INSEE, Comptes de la Nation)



However, a closer look at the data reveals that countries with high public debt are often those which also have high taxes. In Figure 11 below we have used an index of fiscal burden computed in 2005 by the Heritage Foundation as part of their study on an index of Economic Freedom, and OECD data on Public Debt. The results are clear: a higher fiscal burden tends to be positively associated with higher public debt.

Figure 11: Public Debt and Fiscal Burden

Public Debt as % of GDP



The combination of the two phenomena (heavy fiscal burden and high debt) fits many scenarios. One will be an increase in tax rates leading to a substantial increase in tax receipts which, however, will prove insufficient to match the even greater increase in public spending. It could also be that tax pressure (as measured by tax *rates*) is unproductive beyond a certain threshold, i.e., a manifestation of the Laffer curve effect. Whatever the explanation the fact remains: it can hardly be argued that high levels of tax rates are necessary to keep the budget balanced and the level of debt low. Even if this were possible in theory, it is scarcely the case in practice. Looking at similar data on budget balance and tax pressure, Arthur Laffer comments:

“For all the brouhaha surrounding the Maastricht Treaty, budget deficits, and the like, it is revealing—to say the least—that G-12 countries with the highest tax rates have as many, if not more, fiscal problems (deficits) than the countries with lower tax rates. While not shown here, examples such as Ireland (where tax rates were dramatically lowered and yet the budget moved into huge surplus) are fairly commonplace. Also not shown here, yet probably true, is that countries with the highest tax rates

probably also have the highest unemployment rates. High tax rates certainly do not guarantee fiscal solvency.”⁴

Clearly governments do not take on debt to lighten the fiscal burden. At best, they do so in order not to increase taxes even further (perhaps because they are aware of a Laffer curve effect and therefore know that to increase tax rates will lead to little extra net revenues). We would like now to suggest another reason why governments might favour debt over tax: the “political cost” of financing public spending with debt is lower than the political cost of financing that same spending with tax. The reason for this would be that taxpayers don’t consider the two modes of financing as equivalent. The Ricardian equivalence principle does not hold true in practice.

According to that principle, government deficits do not affect the overall level of demand in an economy because taxpayers know that any deficit has to be repaid later and they will therefore increase their savings in anticipation of a tax increase.⁵ Assuming the government wishes to increase spending by €1000, it can borrow €1000 today at 10% or it can increase tax receipts by €1000 today. If the first option is chosen, taxpayers should understand that they will have to pay €1100 in tax tomorrow, which is equivalent to a loss of €1000 today (assuming taxpayers and government have the same access to the capital market. Hence a taxpayer needs roughly to invest €1000 today in order to have €1100 available tomorrow). There has been a large debate, theoretical as well as empirical, to evaluate the soundness of this proposition,⁶ and it is commonly admitted that the equivalence does not hold true if taxpayers believe that someone else will pay the tax bill, or, as Morgan Rose put it in a humoristic way, “if public debt theory and present value calculations are not included in basic, compulsory schooling”.

⁴ See Laffer, 2004.

⁵ Ricardo was aware that this was true in theory but not necessarily in practice.

⁶ See, for instance, Bernheim, 1987.

As Dwight and Cynthia Lee rightly pointed out, however, *if* the equivalence holds true, politicians would respond to public worries about large deficits (and, we may add, to European Union complaints about raising debt and deficits) by switching from deficit to tax financing. But, this is not what we observe.

“The attractiveness of persistent budget deficits to politicians suggests strongly that current taxpayers do not believe that the future taxes they will have to pay because of additional government debt are as costly to them as the current taxes that the debt replaced. If this is the case, then over some range politicians will find it is less costly politically to finance spending through debt than through taxation.”

And they add:

There is no obvious direct measure of the marginal political cost of deficits, so it is difficult to imagine a direct test of the proposition that a decrease in that cost will increase government spending. But a testable implication of such a response to a reduction in the marginal political cost of deficit spending is that an increase in the ratio of deficit financing to tax financing will be associated with an increase in government spending as a percentage of the Gross National Product (GNP).”⁷

We have conducted our own inquiry into the relationship between those two ratios. A positive and significant correlation between them would support Dwight and Cynthia Lee’s claim: when the government chooses to increase debt rather than taxes (a high deficit/tax ratio), public spending increases more rapidly (high spending/GDP ratio). More precisely, we looked into those ratios for 24 consecutive years in France (1980-2003) and found a statistically significant correlation. An increase of 1% of the

⁷ Lee and Lee, 1991.

deficit/tax ratio is associated with an increase of 0,523% of the spending/GDP ratio.⁸

6. A direct evaluation of the relationship between debt and growth

We have found so far that (i) the debt explosion was not caused by an increase in investment expenditures but by increased consumption crowding out private investment; (ii) that the debt explosion has become apparent since the mid-80s because governments were no longer able, so to speak, to pay their debts with inflation; and (iii) that governments keep preferring debt to tax because tax payers “prefer” debt financing to tax financing. Having gathered many theoretical arguments and evidence showing that the recent increase in public debt has not been a factor for growth, it is nonetheless difficult to find *direct evidence* of a negative relationship between public debt and growth; the reason is that many parameters, in addition to the level and nature of public spending and the level of public debt, have an impact on growth.

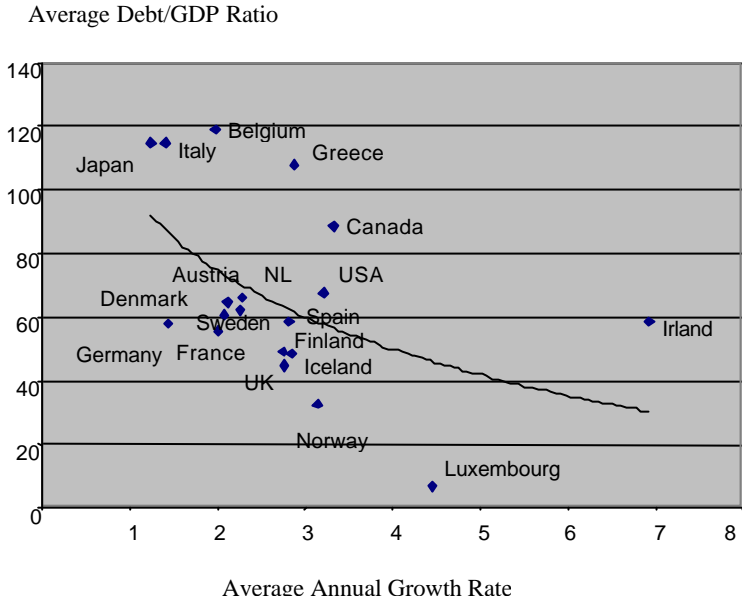
Looking nonetheless for direct evidence, we gathered the average rate of growth for 20 OECD countries for the last 13 years and the average debt to GDP ratio (Figure 12). Plotting these data on a graph and fitting a curve we can read a negative relationship. Although, admittedly, this is not strong evidence, it remains clear from these data that *public debt does not lead to higher growth*.

⁸ Details about that econometric result can be found in an earlier version of that paper available at <http://www.irefeurope.org>

**Figure 12: Growth and Debt for 20 OECD countries
(Sources: OECD Data)**

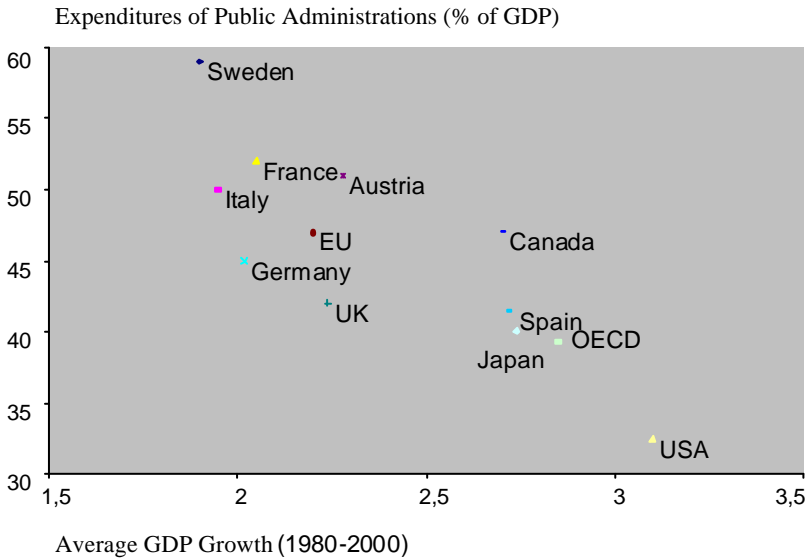
	Average growth rate (1992-2004)	Average debt/PIB ratio (1992-2004)
Belgium	1,98	119
Danemark	2,09	60,8
Germany	1,44	57,7
Greece	2,88	108
Spain	2,81	59
France	2,02	55,7
Irland	6,93	59
Italy	1,41	115
Luxembourg	4,45	6,64
Netherlands	2,29	65,94
Austria	2,12	64,7
Portugal	2	58,53
Finland	2,76	49,2
Sweedden	2,26	62,29
UK	2,77	44,72
Iceland	2,86	48,48
Norway	3,14	32,69
USA	3,23	67,4
Japan	1,25	114,62
Canada	3,33	88,51

**Figure 13: The Debt-Growth Relationship
(Average level 1992-2004)**



If instead of public debt we look at the impact of public spending on growth, we find somewhat clearer evidence. As indicated in the graph below, looking at OECD countries, those with a level of public spending (as percentage of GDP) above average show lower growth in the long run (1980-2000).

**Figure 14: The Public Spending-Growth Relationship
(Source: OECD)**



7. Orientation for public policy with some public choice considerations

As discussed in the first section (Figure 2), if some countries continue to break sad records as far as public debt is concerned (Czech Republic, Germany, France, Poland, Norway, Japan, Malta, Slovenia, Cyprus), there are signs of hope elsewhere. From Figure 2 one can extract the following information:

Figure 15: Is there a general trend towards lower public debt?

	Highest level of public debt as % of GDP (year of the record)	Public Debt as % of GDP in 2003
EU (25 countries)	67,5 (1998)	63,3
EU (15 countries)	72,6 (1996)	64, 3
Eurozone	74,6 (1996)	70,7
USA	75,4 (1993)	62,7

From these data one can draw the conclusion that the necessary policies have been implemented, at least in some countries, to stop a rapid increase of public debt that was most likely detrimental to growth. Let us note that if such was the case, it would not necessarily run counter to the argument presented above, according to which the political cost of financing expenditure with debt is lower than the cost of financing it through taxes. Indeed, it could be the case that the benefits associated with larger debt (namely, avoiding unpopular tax increases) are offset by the costs of debt (lower growth and angry unemployed voters). As far as debt reduction is concerned, there is indeed a collective action problem as pointed out by Robert Higgs. Talking about the ills of an ever increasing deficit, Higgs wrote:

“(...) individual citizens acting on their own can do virtually nothing to remedy these ills. Because people rarely organize for political action except on behalf of some narrow interest, no one is likely to create an effective political movement in opposition to continuing massive deficits. So far as the government’s fiscal irresponsibility is concerned, the immediate future probably will be no different from the immediate past. The deficit will

continue to be like bad weather: everybody will complain about it, but nobody will do anything about it.”

Another explanation for the apparent improvement in debt management is the adoption in 1997 of the Stability and Growth Pact, made necessary by the adoption of a single European currency. This required member countries to bring (or maintain) a debt ratio below 60% and public deficit ratio below 3%. Following this, the shift towards sound public finances would have been somehow “forced from outside”; national politicians would be able to tell their citizens: “we have no other choice, they have tied our hands!” If some truth could be found in that explanation and therefore some good to the tying-your-hands strategy, one must nonetheless recall that two of the biggest players in the game, Germany and France, have felt free to untie their hands.⁹

In a 2003 study completed for the OECD, Joumard *et al.* suggest that any improvement in the debt ratio could be due instead to favourable but temporary circumstances. Among those “favourable circumstances” they list: 1. lower interest rates (that reduce interest charges), 2. privatisation (which brings revenues and, in many cases, reduces future public expenses), 3. peace dividends (at least until September 11, 2001), 4. discretionary and transitory measures (such as freezing civil servants’ nominal wages). It is clear therefore that for those authors a remedy is yet to be found for the ill.

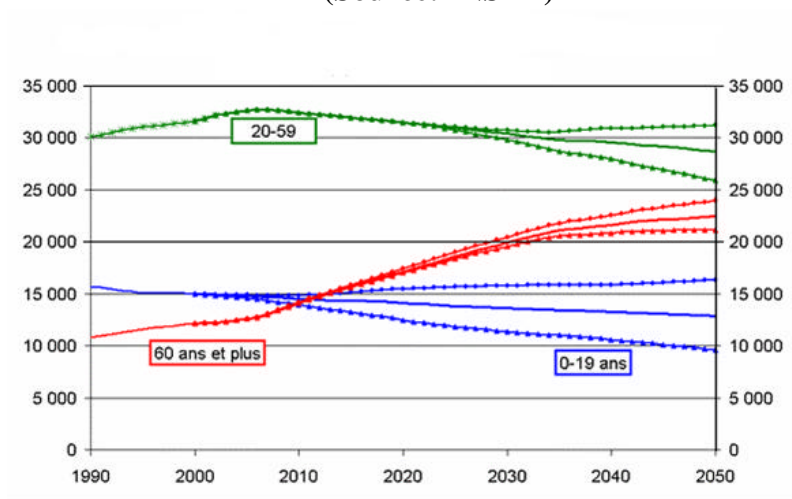
Our study, and in particular our analysis of the structure of public spending, leads us to support their view. Because public spending is comprised essentially of operating costs plus so-called economic and social transfers, we must start to question such types of spending (or at least their levels) and return to investment. Otherwise, there is no doubt that the debt ratio will keep rising. The situation is even likely to get worse when one considers the

⁹ It must be recalled that the Pact fully came into force on 1 January 1999 and, as shown on Figure 15, wherever the debt ratio improvement occurred, this took between 1993 and 2003.

aging phenomenon which might slow growth and will surely raise the necessity and levels of transfers.¹⁰

Figure 16 gives us three plausible scenarios for France. If in 2005 we still have around 32 million productive citizens for 28 millions non-active (below 20 or above 60), the ratio of active to inactive individuals should be around 1 in 2015 and most probably well below 1 in 2030.

Figure 16: Demographic trends (3 scenarios)
(Source: INSEE)



In today's global environment what should our governments do? One route is to attempt to raise funds by maintaining or even increasing the fiscal burden. This route has been taken by some European governments which, not surprisingly, are fiercely opposed to tax competition, fearing that it could lead to lower tax

¹⁰ Those countries which are still glued to a pay-as you-go system are of course in a desperate situation. In France, looking only at current obligations to pay pension funds for civil servants raises the debt from 1,100 bn € to 2,000 bn €

revenues, lower social transfers and higher debt. They claim furthermore that theirs is the only route preserving social peace.

Our study joins a growing literature which urges governments to take another path. Instead of being inspired by fear and the quest for an impossible *status quo*—which is what “social peace” is all about—, it is urgent to give the initiative back to the wealth creators, knowing that:

1. lowering taxes is the best way to improve the price/quality ratio of public services and hence to provide the incentive for the State administration to reform itself¹¹
2. lowering taxes is the surest way to foster growth, as has been recently further documented by Minford and Wang (2005)
3. countries which have a high fiscal burden tend to have a high debt ratio, and debt does not generate growth as shown in that study.

¹¹ See Garelo (2003) for a discussion of the dynamics of fiscal competition and in particular of the race-to-the-bottom argument.

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THE CONFUSED STATE OF MODERN LIBERALISM

Norman Barry*

The dominant political creed of the western world since the collapse of communism has undoubtedly been liberalism but there is great confusion as to what it actually means. Most important is its connection with conservatism. The two most opposed versions of liberalism are what I call *economic* liberalism (or classical liberalism) and *social* liberalism. The former was individualistic and dominant in nineteenth century Europe, especially England, and stressed the importance of free markets, private property, low taxation, light regulation and the minimal state. Although economic liberals believe in civil and political liberties, they very much emphasise the *unity* of liberty in which the right to trade and to contract and property are as important as the right to free expression and religion. The social liberals, dominant in America, are less concerned with economic liberty and emphasise civil liberties and have expanded them to include non-discrimination (widely interpreted) and abortion rights. Also, while not being formally socialist, social liberals welcome economic redistribution so that justice no longer means the following of fair and impartial rules, it also covers

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social justice, i.e., an extensive welfare state and punitive taxation of the rich. Modern American liberalism is perhaps best exemplified in the philosophy of John Rawls.¹ In the United States conservatism is associated with old-style economic or classical liberalism and is best expressed in the economic and social philosophy of Milton Friedman. It is an interesting question – was Mrs Thatcher a conservative or an economic liberal? She exhibited both classical liberalism and conservatism in her politics.

The Transition from Economic Liberalism to Social Liberalism

In England we can almost put an exact date on the change in the meaning of liberalism. It was the election of the Liberal Government in 1906. Prior to that date liberalism under William Gladstone meant low taxes and the minimal state. The economic liberals were concerned about the existence of poverty but limited welfare to the Poor Law – provision of welfare was meagre and subject to strict conditions. They were worried about what is today called *moral hazard*, i.e., a too generous welfare system simply encourages more people to become poor. Economic liberals assume that everybody is a utility maximiser. But the new liberals wanted to absorb everybody in the welfare state through a contributory social insurance system, an idea originally pioneered by Bismarck in late nineteenth century Germany but very influential on English liberals. Also, these liberals began to be influenced by social philosophers such as T. H. Green² and L. T. Hobhouse³, who invented the idea of

¹ John Rawls, *A Theory of Justice*, Harvard University Press, Cambridge, Mass, 1971

² T. H. Green, *Lectures on the Principles of Political Obligation*, Longman, London, 1941, first published 1880.

³ L. T. Hobhouse, *Liberalism*, Oxford University Press, London 1964,

the obligatory nature of *community* against the excessive individualism of the older economic liberals.

This form of liberalism dominated the twentieth century. Also, the fundamental idea of economic liberalism, that a market economy was self-correcting and would eventuate in the full employment of all resources, including labour, began to look less plausible with the emergence of mass unemployment, culminating in the Great Depression of the 1930s. This led to the influence of another feature of social liberalism, Keynesian economics. This put a duty on government to solve unemployment by public spending should there be an excess of private saving and too low private demand.

So by the mid-twentieth century liberalism had been transformed from . minimal state doctrine stressing market individualism and personal responsibility for action into a comprehensive statist doctrine enjoining government action to manage the economy and provide universal welfare. Perhaps the most important philosophical rationale for the new liberalism was provided by the aforementioned John Rawls. Using some very abstract theorizing he claimed that individuals behind a 'veil of ignorance' would contract into a redistributive state that would protect them against the vicissitudes and exigencies of modern life. But Rawls was not a socialist egalitarian. Inequality would be justified if it were to the 'benefit of the least advantaged'. He wanted to preserve the incentives structure of a modern capitalist economy. However, he was very anti-individualist in his claim that our talents and abilities are not owned by us but belong to society.

America, which in practice remained basically free

first published 1924. *Elements of Social Justice*, Allen and Unwin, London, 1922

market, produced the modern theory of social liberalism. It was helped by the Supreme Court which had normally upheld economic liberty. This reached its apogee in 1905 when the Court, in *Lochner v. New York*, struck down a New York state statute that would have limited the hours a week bakers could work. A wide right to contract was read into the Constitution. However, all this changed in the 1930s, from *West Coast Hotel v. Parish* (1936), since then almost all government regulation has been upheld. In fact, the Court has explicitly denied the unity of liberty saying that social and moral liberties would always be protected by the Court over economic liberties.⁴

The Consensus

Such was the electoral power of the new social liberalism that it became a consensus in western democracies which even nominal conservatives enthusiastically joined. When the post war welfare state in Britain was extended under William Beveridge in 1942 and implemented by the 1945 Labour government, the conservatives were fully complicit in its main features. The traditional connection between liberalism and capitalism seemed remote, except perhaps in America, though not in her social theorists. The market system survived but only as a source of income for ever expanding government. Liberals talked a lot about rights but rarely the right to private property, and although freedom was never far from their lips economic liberty was conspicuous by its absence. However, there was a kind of underground economic liberty movement but it only had any appeal when the consensus itself began to break down. And then the classical liberals had scientific explanations for its failure as

⁴ See Bernard Siegan, *Economic Liberties and the Constitution*, University of Chicago Pres, Chicago, 1980.

well as sound normative arguments for its replacement by a revitalized economic liberalism. This has to an extent happened.

In the 1970s the consensus first began to break down when Keynesian methods of economic management produced economic disorder wherever they were tried. The social liberals assumed that there was a stable relationship between inflation and unemployment via the 'Philips curve', that government could pick any level of inflation it wanted so as to produce full employment. But in the long run these Keynesian methods failed: the result was inflation *and* unemployment. In the jargon, the Philips curve was vertical. All this was demonstrated by the economic liberals led by Milton Friedman at Chicago University in America. Monetarism became the standard feature of the new economic liberalism, and the provision of a stable and reliable currency one of the few basic responsibilities of government.

The welfare state became a major target of the new economic liberals. Welfare spending rose whatever the state of the economy. And particularly in America it produced undesirable social consequences in the way of the rise of unmarried motherhood, family breakdown, vastly increased drug use and the decline of personal responsibility for action.⁵ In Britain especially, the excessive state welfare was proving to be a drain on the economy, particularly as social insurance proved incapable of financing the welfare responsibilities and they came to be financed by tax funding. Again in Britain, the rule of law came under strain through disruptive action by trade unions.⁶ They broke labour

⁵ For critiques of pre-1996 American welfare, see Charles Murray *Losing Ground*, Basic Books, New York, 1984 and Lawrence Mead *The New Politics of Poverty*, Basic Books, New York, 1992.

⁶ See Norman Barry 'Thatcher's Conservatism: An Hypothesis' in Sobruto Roy and John Clarke eds *Margaret Thatcher's Revolution*,

contracts with impunity and used intimidation and violence in strikes. Repeated attempts by both Labour and Conservative governments to bring them under the rule of law failed. Also efforts by governments to equalize income redistribution by high taxation and prices and incomes policies simply produced a misallocation of labour.

What was remarkable in this pattern of events, which had a common cause, the expansion of government, was the passivity of conventional conservatives. They were too complicit in the consensus to object too strongly and too hungry for office to dare to challenge conventional 'wisdom'. The prime example of this conservative passivity was the Edward Heath government of 1970-74. It continually interfered with the private economy, bailed out bankrupt companies, surrendered abjectly to militant unions and in a desperate attempt to stem rapidly rising unemployment pushed inflation to 20 per cent per year.⁷

There was one important exception to the consensus in Europe and that was post-war West Germany where the adoption of the 'social market economy' under Ludwig Erhard generated a remarkable economic recovery after the devastation of war. However, the social element gradually replaced the economic element so that Germany eventually resembled an orthodox social democratic state,⁸ worn down by welfare and excessive regulation. The ideas of classical liberalism were lost for a generation.

Continuity Books, New York, 2005, pp. 177-89.

⁷ See Norman Barry, 'The New Right' in Kevin Hickson ed *Conservative Political Thought since 1945*, Macmillan, London, 2005, pp. 30-9.

⁸ See Norman Barry 'The Social Market Economy' in *Social Philosophy and Policy*, vol. 10, 1993, pp. 1-25.

The New ‘old’ Liberals

A version of classical or economic liberalism was the only intellectual force capable of coping with the social crisis accompanying the collapse of the consensus. But there were at least three versions: that deriving from the Austrian school of economics led by the naturalised Briton Friedrich von Hayek,⁹ the aforementioned Chicago school of economics led by Milton Friedman and the new school of ‘public choice’ under James Buchanan and Gordon Tullock in Virginia, USA. Robert Nozick in *Anarchy, State and Utopia*¹⁰ gave an original and sophisticated philosophical backing to these ideas.

Hayek combined anti-inflationary economics with a subtle philosophy of liberty. He had first come to prominence with his *The Road to Serfdom* (1944)¹¹ where he argued that even minor interferences with the free economy would put a nominally free society unintentionally on the path to totalitarianism. His later work was concerned with the institutional framework for a free society and the rule of law. These themes were explored in *The Constitution of Liberty* and the three volumes *Law, Legislation and Liberty* (1973, 1976 and 1979¹²). Especially important was his attack on that canonical symbol of social liberalism in his *The Mirage of Social Justice* (1976).

Hayek believed that all value is determined by market exchange and that any attempt to redistribute income by the

⁹ See Norman Barry, *Hayek’s Social and Economic Philosophy*, Macmillan, London, 1979.

¹⁰ Robert Nozick, *Anarchy, State and Utopia*, Blackwell, Oxford, 1974.

¹¹ F. A. Hayek, *The Road to Serfdom*, Routledge and Kegan Paul, London, 1944.

¹² F. A. Hayek, *Law, Legislation and Liberty*, Routledge and Kegan Paul, London, 1986.

state is to destroy value by misallocating the factors of production. It is also the end of the rule of law by replacing natural and conventional rule-governed processes by arbitrary command. Value is determined by free exchange and to interfere with this would be immoral as well as inefficient. The state is not a grand distributor. The rule of law is preserved only if laws are perfectly general and name no one. Then they are quite consistent with liberty, for to be unfree is to be commanded to do something. People can only conduct their lives in peace and security if rules are known in advance and do not discriminate. Only in such security can people's entrepreneurial talents be released for the good of mankind. Hayek felt that the case by case development of the common law, by judges imbued with the proper idea of legality, was better than law by a code, as in the civil law of Europe. He felt that no designed legal code could encompass all future circumstances: it was an epistemological impossibility. Legislative activity should be restricted to making minor improvements to the rules of just conduct which are essential for predictable market exchange. The market itself is uncertain, we cannot know in advance future tastes or production costs, which is why socialism must fail, but nevertheless transactors require a certain and predictable legal framework. Socialism, by operating through a system of arbitrary commands destroys that predictability. Hayek probably did not think that piecemeal intervention in markets would inevitably produce totalitarianism, but that it would undermine freedom and efficiency.

Milton Friedman did not explore these philosophical aspects of liberty but took a simple utilitarian view of the connection between free markets, prosperity and free institutions. In his *Capitalism and Freedom* (1962)¹³ he went beyond monetarism and applied free market economics to a

¹³ Milton Friedman, *Capitalism and Freedom*, University of Chicago Press, 1962.

number of social and political issues. In this approach he made great use of the empirical method, something absent in Hayek. Thus he could easily show that rent control actually causes homelessness by reducing the supply of rented property and that the minimum wage causes unemployment by rendering workless those whose marginal product is worth less than the minimum wage. More interesting was his treatment of welfare. He did not deny that we had altruistic sentiments but thought that there had to be some state action because he claimed that certain problems prevented the entirely voluntary supply of welfare.¹⁴ I cannot be *assured* that others will be as generous as me. But he did not at all accept the conventional welfare state with its coerced supply of health care, education and pensions. He pioneered the Negative Income Tax in which cash is paid to those whose incomes fall below a certain level. They would be free to spend it as they wish. Nationalised health care always meant less spending and denied patients choice. And pensions once again put individuals at the mercy of the state and people would always earn more money for their retirement if their taxes were invested privately in the stock market than returned to them in the form of state pensions. There are other issues in which Friedman's radicalism caused great controversy: he opposed the draft and was extremely hostile to restrictive drug laws.

Perhaps the most original contribution the modern economic liberals made to liberal social theory, and indeed to social science, was the development of public choice theory. This was the application of microeconomic theory to the behaviour of public officials. It refutes the notion that public officials are disinterested providers of the public good; in fact they are utility maximisers who use public office to advance

¹⁴ For a critique of Friedman's welfare theory, see Norman Barry, 'Friedman' in Vic George and Robert Page, eds, *Modern Thinkers on Welfare*, Prentice Hall, New York, 1995, pp. 31-39.

their own interests.¹⁵ In the jargon of modern economics, they are ‘rent seekers’ who divert the extra value created in a capitalist economy to themselves. They do not pursue profit but seek better salaries, pensions, smarter offices and prettier secretaries for themselves at the cost of the public. Modern democracies resemble battlegrounds on which rival interest groups fight for rents. New Labour in Britain might have abandoned old fashioned socialism but it has created 800,000 more public servants, all on high salaries and incredibly generous pensions. They are doing useless jobs. Majority rule democracy can do little about this since the parties tend to represent interest groups anxious to protect their non-market privileges – these often include protection for home industries from foreign competition. Just look at European Union farmers as a successful example of rent seeking. All this makes everybody worse off but no political party has any incentive to change it. This should not be taken to mean that economic liberals are against democracy. But they do have doubts about majoritarian democracy, for this encourages the formation of socially destructive interest groups: direct democracy, through referenda on separate issues, discredited by conservatives, might be a better way of making public decisions.

Undoubtedly the revised form of classical or economic liberalism has achieved considerable success in refuting social liberalism in the last twenty years, especially in Ronald Reagan’s America and Margaret Thatcher’s Britain. But the advance of economic liberalism was a world-wide phenomenon which was sometimes pioneered by social democratic governments. In New Zealand a Labour Government and its finance minister, Roger Douglas, reversed much of the economic interventionism produced by

¹⁵ See James Buchanan and Gordon Tullock, *The Calculus of Consent*, University of Michigan Press, Ann Arbor, 1962.

the preceding Nationalist (Conservative) government and in Australia a Labour Government relaxed most of the protectionism which had stultified the country for decades. But in most countries the welfare state survived as the symbol of social liberalism. America was the exception here and its social cost and moral hazard were seriously reduced in 1996. Elsewhere, entrenched interest groups, as public choice predicts, managed to resist the reform of costly welfare. With all of this conventional or orthodox conservatives had little to do, or even say. They had an uncritical disposition towards the past which impeded serious economic liberal innovation or even reform. Mrs Thatcher had great difficulty in persuading her own party of the need for radically challenging the consensus.

Liberalism in Japan

I am a complete beginner to Japanese politics so that much of what I say on the subject is speculative. However, the country is interesting from an economic liberal perspective because although it is broadly capitalist, there has never been much socialism in the country; it is significantly different from the Anglo-American model I have discussed. Since the end of the second world war Japan has broadly conformed to what I have called social liberalism, so much so that socialists disenchanted with old-style collectivism have used it as a model for the 'Third Way', some kind of midway position between collectivism and free market capitalism. Some features of Japanese capitalism are different: there is less concern with shareholder value and takeovers are rare, especially by foreigners (Nissan's takeover by Renault being exceptional). The economy is much more communitarian and less individualistic than the Anglo-American model. It is also less legalistic: transactors rely much more on 'trust' than formal contract. The Japanese economy was vastly successful, the world's second biggest, without being quite

capitalist. However, the bursting of the ‘bubble’ economy in 1990 and the consequent prolonged recession have forced the Japanese to rethink their liberalism.

The key figure in this has not been an intellectual but a politician, the current prime minister, Mr Junichiro Koizumi.¹⁶ And he seems to have clear economic liberal intentions. He wants to free up the economy and expose it to competitive pressure, to reduce the burgeoning size of the state and to make Japanese economic society more Anglo-American. His long-held desire to privatise the post office is a very good example of his approach. There is nothing wrong with the Japanese postal system itself. From my own experience, despite being nationalized, it is highly efficient at delivering letters and parcels. The problem is that it is also the world’s largest savings bank, controlling 3 trillion US dollars (and it is also an insurance system). What Koizumi wants to do is to free up the capital market so that that money is invested in the still productive private sector. Though how he will persuade the Japanese to invest in stocks after their bitter experience of the 1990s is difficult to say. At the moment all that money in the post office is used to buy government bonds which are spent on a burgeoning public sector. Roads that go nowhere and a small town that has two airports and only ten flights a day. Initially Koizumi’s biggest problem was his own party, the Liberal Democrats, which is deeply conservative in the sense described above. In this case public choice becomes highly relevant, for these government projects provide jobs and careers for Liberal Democrat supporters. If government spending could provide job prospects for Liberal Democrats the latter could wheel out the vote. That is why the Liberal Democrats have been in power for most of the past fifty years. And Mr Koizumi was right to conduct the last election as a Swiss-style referendum on

¹⁶ See Norman Barry, ‘Japan, Germany and the End of the Third Way’, *The Freeman*, vol 56, 2006, pp. 22-26.

postal privatisation. When issues are bundled up in party programmes public choice teaches us that rent seeking and interest group politics dominate. Switzerland, with its regular use of the referendum at federal and cantonal levels is the only example of a modern democracy breaking the logjam created by interest group politics.

Then there is the problem of deflation, which has bedevilled the Japanese economy for more than decade. For nineteenth century economic liberals a gently falling price level would not have been a problem. In the heyday of the gold standard Britain had that with no ill-effects. But now we have the problem of the 'subjectivism of expectations', a theory also developed by economic liberals. If prices are falling, people may think they will fall even further and therefore delay their spending until they have to purchase goods and services, hence impeding growth. And given the Japanese legendary propensity to save, it is not at all surprising that the country should be trapped in downward a spiral: the economy then may not be as self-correcting as the older classical liberals thought. But they would still say that inflation, which threatened to ruin western economies in the 1960s and 1970s, is much worse than deflation.

Now, with the stock market and land prices up, the Japanese are well on the road to recovery but this has happened through the adoption of old-fashioned economic liberal methods. But even bigger problems lie ahead, notably welfare costs, especially pensions, exacerbated by Japan's declining birth rate. Those western critics of capitalism who touted Japan as the Third Way, more communitarian and less 'greed' driven than the decadent west, are simply wrong. The only social doctrine consistent with all we know of human nature and social processes is economic liberalism. All the other notions of liberalism are ersatz, bogus versions of the models of David Hume, Adam Smith, Carl Menger and Hayek.

Conservatism and Economic Liberty

Conservatives do not take naturally to economic liberty. In fact they show a distrust of any kind of abstract theorising about economics and politics. However, the collapse of the Liberal vote in the early twentieth century and the rise of a much bigger threat, socialism, compelled many conservatives to adopt a pro-capitalist position, albeit reluctantly. Indeed, many of the market reforms of the late twentieth century were instigated by nominally socialist governments. But it cannot be denied that free marketeers realistically have nowhere else to go but to conservative ranks. If they do believe that ideas and not interests determine the course of events, they must hope to persuade unthinking conservatives of the virtues of free markets, private property and capitalism. The power of imitation is very important and the obvious success of market economies has had an effect world-wide: classical liberalism may never be popular but its practical success is irresistible. Even the current Labour government in Britain has been compelled to abandon old-style socialism and present itself as a supporter of free enterprise. But it is still a statist party reluctant to extend the market to welfare and health care and it has increased public spending and taxation.

But have the Conservatives used classical liberalism to counter this squandering of the Thatcherite legacy? Clearly not, for they seem more concerned to appear ‘modern’, being sympathetic to gays, women and ethnic minorities than to worry about economics. But the laws of economics are, as classical liberals have tirelessly pointed out, not traditional or dated, they are timeless.

MIGRATION AND LIBERALISM*

Robert Nef[†]

There is no such thing as a classical liberal response to the question, “Are you in favour of free immigration?”

Let me start with the famous answer given by Monsieur de Gournay, son of a merchant in 18th century France. When asked, what the government should do to promote merchants, he replied, “Laissez faire, et laissez passer”, let people work as they please and go where they want.

The quotation forms the basis of what is known as *laissez faire* liberalism, and it is perhaps no coincidence that the reference to “laissez passer” is no longer quoted: immigration is no more popular today than it was in feudal times when kings were interested in having more subjects and more soldiers—the more the better.

Monsieur Gournay offered the classical liberal answer.

I remember Milton Friedman’s answer in a televised interview at the ISIL Congress in Costa Rica in 2002.

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Question: “Professor Friedman, are you in favour of free immigration?”

Answer: “Yes, I am in favour. But you cannot simultaneously have free immigration and a welfare state.”

While this may be a good answer, it solves neither the problem of illegal immigration nor the problem of an orderly retreat from the welfare state. It serves as an excellent excuse for classical liberals and libertarians when they struggle to find the right solutions to the problems of free immigration. It is no surprise that the welfare state in Europe is unsustainable and is in trouble. However, it cannot be dismantled overnight. Neither can we wait for a solution to the problem of immigration, especially illegal immigration, until we have solved the problems of the welfare state.

While I have no solution to offer, I will present three approaches, which, though different, nevertheless all qualify as liberal.

Wikipedia defines open immigration as follows: “Free migration or open immigration is the belief that people should be able to migrate to whatever country they choose, free of substantial barriers. Although the two are not the same issue, free immigration is similar in spirit to the concept of free trade, and both are advocated by free market economists on the grounds that free markets are the best way to create a more productive economic system, thereby increasing the overall economic benefits to all concerned parties. Paradoxically, many libertarians, socialists and anarchists advocate open immigration, notwithstanding other noteworthy differences among these three political ideologies.”

Immigration – even illegal immigration – has its positive aspects.

Recent bills to reform U.S. immigration laws, especially the controversial bill passed by the House of Representatives

last December, fail to recognize the enormous positive contributions of undocumented workers to America's economy. "Even the more progressive McCain-Kennedy immigration bill that the Senate Judiciary Committee passed last week – which would permit about 400,000 new guest workers each year and provide a path leading to permanent residency after six years – falls short", according to Benjamin Powell, director of the Independent Institute's Center on Entrepreneurial Innovation.

"Why allow only 400,000 guest workers per year?" asks Powell in his latest op-ed. "Since they are good for the economy, shouldn't we welcome as many as employers are willing to hire?"

Powell also argues that proposed guest-worker programmes should "keep administrative burdens on employers to a minimum and must allow workers the flexibility to easily change jobs in our constantly evolving economy."

To continue with Wikipedia: "Arguments against free immigration are similar to arguments against free trade, for example, protectionism, which critics claim to be xenophobia. Specifically, an influx of cheap labour could easily deflate wages for workers who are already established in a particular labour market, and (at least in the short term) have a negative impact on the standard of living for the more established workers. Other critics of free immigration are concerned that it would be unfair to current homeowners if an influx of new residents greatly brought down the property values and attractiveness of living in that location, or, alternatively, increased the demand to live in the city so much that the homeowner would not be able to keep up with increased taxes from higher property values. However, free market economists believe that competition is the essence of a healthy economic system, and that any short-term negative impact on individual economic actors that is caused by free

immigration is more than justified by the prospects of long-term growth for the economy as a whole.”

Is open immigration compatible with the principles of the classical liberal society?

This society builds on the self-determination of the people, not political organisations. Both contractually and compatibly these self-determined people must be able to formulate and agree on the rules necessary for co-existence and constantly adapt them to new situations.

It builds on a large number of small, non-central, competing and cooperating units, not central political control. In millions of small and micro experiments, people must learn together through trial, error and interaction.

It builds on diversity, not egalitarianism. Civil society is nothing other than peaceful coexistence, cooperation, occasional confrontation and frequent confusion between different people.

It builds on flexible roles and life patterns. In the "school of life" there are no fixed roles for instructors and learners. Everybody alternates between being a teacher and a pupil. The fundamental principle is mutual consideration and respect for human dignity.

It builds on transparency and communication. "Cribbing" is not only permissible, it is encouraged. Success is to be copied and expanded, mistakes are to be avoided or at least reduced.

It builds on self-reliance and on taking responsibility for oneself. Anyone who plays truant from the "school of life" and the "school of the market" must bear the blame and the consequences.

This manifesto is not just the quintessence of a dogmatic neoliberal ideology. In a closely networked world based upon the division of labour, it actually has a chance of medium- to

long-term success. The crucial question is not "What is socially just?", but "What works?", — after all, something that does not work cannot be just.

Does free immigration work?

I will try to describe three liberal approaches to immigration and use names for the different models.

First, the **“Gournay model”**

Laissez faire, laissez passer, without any restrictions. It only works within a non-welfare-state framework that does not offer any benefits not financed by the immigrants themselves.

Second, the **“Mises model”**

The classical liberal Ludwig von Mises (an Austrian economist who emigrated to the USA in 1940) was in favour of free immigration. Of course he was also aware that while a nation state offers several benefits to its people, these benefits cannot be offered for free to all immigrants. “There ain’t no such thing as a free lunch.” In other words, citizens have the right to fix a price for membership of the club called a nation state. All those willing to pay the price must be accepted without discrimination.

This system is based on the notion that the state is an institution open to those prepared to pay the entrance fee or those who can find a person or an institution who is ready to pay an advance.

The model may not be the practice in Switzerland as a whole, but some small jurisdictions in some Swiss cantons have systems that approach it.

The Swiss system of citizenship is based on local, cantonal and national citizenship, local citizenship being the most important and the most difficult to obtain. However, if the immigrant is ready to pay the price, the process can be much easier, at least in some smaller mountain communities.

Third, the “**Röpke model**”. Röpke was a German economist who was forced to emigrate to Switzerland because of his opposition to Hitler.

The model is based on a completely different philosophy of citizenship.

Röpke believed that the political community is a corporation of free individuals. One of the most fundamental rights is the right to determine who is to be granted club membership. In fact, to obtain citizenship and even the right to immigrate depends on being elected as a new member of the community. This approach is not unlike the Swiss solution. At the local level in some cantons people are asked in an open election whether they are ready to accept a person as a new citizen. They have the right to vote against the motion without any arguments.

The Swiss Supreme Court recently rejected this radically democratic approach and several smaller communities have been compelled to change their rules and regulations.

While it is true that immigration to Switzerland, which can be temporary, is subject to less stringent rules than the acquisition of citizenship, the two issues are closely interwoven. An exception is the asylum law for political refugees whose lives are under threat in their countries of origin. Drawing a distinction between economic migrants and political refugees in Switzerland repeatedly poses awkward questions regarding the procedure to be followed and always leads to problematic individual cases.

Immigration and the minority question

A country can benefit greatly from minorities that share the language and mentality of neighbouring states and important trading partners. For the majority population the protection of minorities is a necessary price to pay, in compliance with international law. The obsession with the

expenditure side has prevented us from realizing the full potential of the minority issue when risk-minimisation makes way for opportunity-maximisation. In an open society, diversity is an opportunity and not a handicap.

Minorities should not fear heterogeneity and overlapping identities. Immigrants often fall victim to the ideal of ethnic purity and consequently may adopt this principle themselves in their dealings with the outside world. Albeit understandable, this is hardly the best survival strategy. Minorities would be better advised to adopt and adhere to the following motto: "If I want to be accepted by the majority, I should bring some benefits. I will then be respected not because of my cultural status but because of the benefits I have to offer."

Over-protecting immigrant minorities "from above" or "from outside" can stifle the growth of a minority-friendly environment. The best way of dealing with immigrants lies in the principle, "I am accepting you because you bring me a net benefit even though you are different". However, a principle like this cannot be translated into practice through compulsion or subsidies. On the contrary, such measures may be counterproductive, as they may exacerbate the existing tension and the propensity for aggression.

Assistance for minorities offered by the central authorities may not only anger the majority (envy), but can also hamper the minority in its efforts to stand on its own feet. If one walks on crutches for too long, one eventually forgets how to walk without them. Minorities should not be discriminated against or persecuted. By the same token, however, they should not be seen as people in need of social assistance in their efforts to survive. If this kind of minority protection based on "enlightened self-interest" is not artificially supported "from above" or "from outside", there must be a mechanism of highlighting the beneficial contributions of minorities. Initially it may appear naive to

purport that such a mechanism may arise spontaneously of its own accord.

The mechanism most suited for underlining the advantages of diversity and heterogeneity is the mechanism of competition — the peaceful competition of systems and countries.

At first it may appear that homogeneity, ethnic purity and centralisation are more successful in economic terms. However, in the vast majority of cases, this assertion cannot stand up to the test of history. Particularly now, in the modern age of globalisation, the benefits of diversity, ethnic impurity, overlapping systems and non-centrality will become more apparent. Heterogeneous societies will make rapid progress and put this to good use. Countries that have undergone such experiences could share them with others. However, in the name of ongoing diversity, they should not aspire to serve as permanent and universal examples.

Each minority problem and each group of immigrants is a special case. Examples from other parts of the world may be helpful, but all the minorities and majorities in actual conflicts must find their own way to peaceful coexistence, through peaceful competition, cooperation and by sharing the profits of good business. We cannot expect animosity between different ethnic, linguistic and religious groups to be transformed into sympathy in a matter of a generation or two.

If different groups compete and cooperate in free markets, and if they have to solve their political problems through plebiscite they soon discover that peace is the most successful and profitable strategy. It is possible for different groups to conduct successful business together with a minimum of national solidarity. Open markets do not create common emotions but they do foster peace, loyalty and fairness.

The Swiss experiment shows that people can live together in the same nation state quite successfully without

extensive networks of mutual sympathy and without national patriotism that runs deep in all.

Classical liberals see immigration as an opportunity and not a burden.

However, we should be honest enough to admit that every community has the right to define membership. When the result of immigration leads to a higher proportion of people who are ready to do the dirty work, it impacts negatively on the social structure of a country. Switzerland was successful in the nineteenth century because it encouraged the immigration of elites.

To limit immigration and allow new citizens to be selected as new members of a club on the basis of enlightened self-interest is not illiberal.

If a country allows in immigrants whose chances of integration are virtually non-existent, it solves one problem by creating a new one. It is better to say ‘no’ at the border, than to discriminate against immigrants inside the country.

A liberal immigration policy must therefore always try to combine the following divergent principles:

1. Gournay’s “Laisser passer” concept
2. Mises’ pricing concept
3. Röpke’s “membership by consent” concept.



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