Excessive public debt: Prevention is better than cure

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**Publishing information**

Text  Economic Analysis and Policy Advice (EAPA)  
Bundesgasse 3  
CH-3003 Berne, Switzerland

Translation  Central Language Services FDF

E-Mail  oekonometeam@efv.admin.ch  
Internet  www.efv.admin.ch/e/index.php  
http://www.efv.admin.ch/e/dokumentation/publikationen/arbeiten_oekonometeam.php

Layout  Webteam FFA, SPK  
ISSN  1660-7937
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Executive summary

Recent crises have shown the economy to be more volatile than previously imagined. As this also affects public finances, it is important to maintain a fiscal buffer so as to be able to respond to future unknown challenges.

Public debt has various consequences, which we discuss here in detail:

- **Public spending**
  The greatest impact of the availability of debt financing is probably that it encourages a government to spend beyond its means. Indeed, various government failures could lead a country to take on excessive debt. Debt may certainly be useful in stabilising or kick-starting the economy in times of crisis or to finance public investment spikes. However, debt should also be reduced in times of economic boom or when public investment is below average.

- **Growth**
  The issue of the impact of debt on growth has spawned much debate in academic circles and in international organisations. It is a difficult issue, as it entails more than simply observing a correlation. The direction of causation must also be assessed (to what extent are we observing the impact of debt on growth as opposed to that of growth on debt?), and the other factors influencing growth also need to be taken into consideration. Despite certain objections (notably from Alberto Alesina), it seems to be the case that when a government runs up budgetary deficits, this has a favourable impact on growth in the short run (and vice versa, an austerity policy will have a negative impact). However, the impact of the debt level is likely to be negative if it exceeds a certain threshold.

- **Intergenerational redistribution**
  The impact on future generations is complex. This is not measured simply by the amount of debt or the interest due. We also have to consider that some members of future generations will receive public bonds (and thus also the corresponding interest). To the extent that a country borrows from its own residents, the impact on future generations consists primarily of postponing to future generations the distortions associated with tax and the effort needed to meet the objectives of intragenerational redistribution. To the extent that a country issues debt to residents of
foreign countries, the impact on future generations is greater, as these are the generations who will have to repay abroad the loans taken out by previous generations. Debt is only one element of intergenerational redistribution. It should be noted that the intergenerational redistribution created by debt is less if this debt is used to construct or preserve other elements that will be passed on to future generations, such as public investments or natural resources.

• Current account
  The impact on the current account is not crucial for Switzerland, although it may be for other countries.

• Risk of default
  As we have seen in the current crisis, a high debt level may lead to a risk of default, even in an advanced economy.

• Public securities on financial markets
  Public debt provides the financial markets with safe securities. This does not justify a high debt level, however.

There are several possible ways excessive public debt can be reduced:
- Spending cuts and tax hikes
- Economic growth
- Sale of assets
- Interventions by the central bank (debt monetisation, inflation)
- Default or “voluntary” debt restructuring
- External support

Some of these remedies, such as central bank interventions, would not be possible in Switzerland. Moreover, the remedies that an over-indebted country is forced to implement generally have negative side-effects.

Prevention is better than cure for two reasons: firstly, so as to avoid high risk premia (or even being unable to borrow) and the threat of political paralysis, and secondly, so as to prevent the side-effects of a fiscal consolidation that suddenly becomes necessary when debt is excessive. When such measures
have to be implemented all at once and during an economic crisis – the worst possible time – their consequences are particularly hard to bear.

In Switzerland, such situations are largely prevented by institutional mechanisms:
- Direct democracy
- Federalism
- Fiscal rules

It is important to anticipate possible changes that could threaten public finances (in particular demographic ageing) and to mitigate the risks of disaster (e.g. default risk of a bank that is “too big to fail”). There should be sufficient fiscal leeway to be able to respond to a possible crisis.
1 Introduction

The present crisis in the eurozone has highlighted the importance of keeping public debt under control. In some countries, public debt is at the very root of the crisis. But even when that is not the case, a country entering a crisis with sound public finances is more likely to have the fiscal leeway needed to overcome it. A number of international organisations have recently published papers on fiscal consolidation: the OECD, for instance, stresses the importance of a safety margin against future adverse shocks (OECD, 2012) while the IMF underscores the need for adequate fiscal space (IMF, 2012).

Given the risk of policy slippages, we believe that prevention is better than cure. The policy efforts needed to maintain public finances on a sound footing are more palatable and politically easier to implement when spread out over a period of time. Consolidating public finances while the economy is booming is preferable to being forced into fiscal tightening after a crisis hits, especially as austerity measures tend to prolong the crisis. Moreover, it is in a country’s own interest to avoid having to pay high risk premia (or even reaching a stage where it is unable to borrow) due to excessive debt.

In this paper, we begin with a brief outline of the current situation (Chapter 2), followed by a discussion on the consequences of debt (Chapter 3) and the various means of reducing excessive debt (Chapter 4). We then point out some of the institutional instruments used to prevent excessive debt in Switzerland (Chapter 5) before reaching our conclusion (Chapter 6).
2 Public debt in Switzerland and around the world

2.1 Past and current situation

OECD countries between 2007 and 2011 (gross debt, i.e. assets are not deducted from debt).

Figure 1: Gross government debt in 28 OECD countries between 2007 and 2011 (% of GDP)

The chart below shows how the debt-to-GDP ratio evolved in 28 OECD countries between 2007 and 2011 (gross debt, i.e. assets are not deducted from debt).

Source: OECD (2012)
Even before the crisis, some countries were already facing high public debt. In Greece, for example, a country that was living beyond its means, it was public debt that caused the crisis. This, in turn, led to even higher debt levels, culminating in a debt restructuring plan forcing private investors to waive a large part of their claims. The situation was quite different in Ireland, however, where the debt ratio was low prior to the crisis and subsequently surged when the government bailed out the banks. Spain's debt ratio, although lower than Switzerland's in 2007, is now higher as a result of the crisis it faced when the bubble on the real estate market burst. Spain's debt ratio is nonetheless still lower than that of Germany.

Even in those countries where the crisis was not caused by public debt, it is clear that sound government finances are crucial to preserving enough fiscal space to respond to the crisis. Governments need to be in a position to allow the automatic stabilisers to operate freely (automatic fall in receipts as a result of the crisis, combined with an automatic rise in certain expenditure, such as unemployment insurance), and also, if necessary, to finance discretionary measures to prop up demand in a serious crisis, for instance, or to maintain financial market stability. Entering a crisis while in poor fiscal health may not only prevent policymakers from resorting to discretionary measures, but even prevent them from allowing the automatic stabilisers to function.

For Switzerland, the crisis so many advanced economies are facing at present poses not only a lesson to be learnt but also a threat. Even if the Swiss National Bank successfully defends its minimum exchange rate, the strong franc is likely to make an impact for some time yet. What's more, the eurozone crisis has not yet been resolved. It could become even more serious, which would damage our exports even more. Despite the progress made on the Greek debt situation, the eurozone could still succumb to a systemic banking crisis.

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1 The increase in general government debt in the G-20 advanced economies was primarily caused by an automatic loss of receipts due to the recession (according to IMF estimates, this automatic loss is responsible for almost half of the increase in public debt between 2008–15). See Cottarelli (2011).
that would also affect Switzerland’s big banks. According to the OECD (OECD, 2011), eurozone banks have significant exposure to sovereign and private debt in the vulnerable countries of the eurozone.

Switzerland’s debt level is modest by international standards. Nonetheless, federal debt rose considerably in the 1990s when Switzerland suffered a collapse in the real estate market and years of economic stagnation. It was because of this increase in public debt that the Swiss federal government introduced a fiscal rule aimed at a medium-term balance between federal expenditure and receipts, i.e. the debt brake (see Chapter 5).

**Figure 2:** Progression of Swiss public debt at federal level (% of GDP)

Source: Geier (2011)
2.2 Future situation

Irrespective of the present crisis, demographic ageing and rising health costs place a significant burden on public finances. The “fiscal gap” provides an estimate of the action needed today and maintained for each year to achieve a given debt objective at the end of a certain period. It thus takes account of the current debt level as well as future fiscal balances until the given year. The following chart shows the fiscal gaps in various countries, representing the action needed to achieve gross debt of 50% of GDP in 2050.

Figure 3: Fiscal gap for debt equivalent to 50 % of GDP in 2050 (% of GDP)

Source: OECD (2012)

Clearly, the extent of the public debt problem can change when future challenges are taken into consideration. For example, Luxembourg now has much lower debt (as a percentage of GDP) than Italy but needs to make a far greater effort to attain the 50% target for 2050. In Switzerland (CHE on the chart), the challenge is less than in other countries but remains substantial nonetheless.
The FFA recently published two studies seeking to incorporate a long-term perspective into Switzerland’s financial plan. According to our Report on the Long-Term Sustainability of Public Finances in Switzerland (FDF, 2012) the fiscal balance of the entire general government sector would have to be improved by 1.8% of GDP (either by expenditure restraint or by higher receipts), i.e. some CHF 10 billion based on current GDP, in order to have the same debt level in 2060 as in 2009. We have also studied in detail the impact of rising health costs (Colombier, 2012). Total healthcare spending (public and private) represents a growing proportion of GDP. In the baseline scenario, it increases from 11.3% of GDP in 2009 to 15.8% in 2060. Around half of this increase is due to demographic changes, while the other half is attributable to various other factors such as an increase in demand for healthcare services. Demographics play a more important role in the health costs covered by public bodies, particularly the cantons, because long-term care represents a larger proportion of public healthcare expenditure than of total healthcare spending.
3 The consequences of debt

Much is said nowadays about the negative aspects of debt and its consequences. We should not forget, however, that the state benefits when debt is issued. This chapter is structured according to the various areas of impact: on public spending, growth, intergenerational redistribution, the current account, the risk of default, inflation and other associated areas.

### 3.1 Public spending

While the availability of debt financing may encourage the squandering of public funds, it can also prove a useful tool in combating an economic crisis and financing investment spikes.

**Availability of debt financing encourages squandering**

As long as a country can borrow, it may be tempted to live beyond its means. Indeed, various factors may lead a country to accumulate debt. As its lifetime is unlimited, the state can in principle continue to postpone the date of repayment of its debt indefinitely. Moreover, the public budget is determined not directly by the citizens but by their elected representatives, also a fact that may produce a stronger debt bias. For example, the fiscal timeframe of elected representatives may be limited by the duration of their mandate. In Chapter 5 we discuss such institutional issues in further detail and discuss possible remedies.

**Debt within the context of economic stabilisation policy**

Fiscal policy can stimulate demand in times of crisis (we will discuss this further when we look at the impact of debt on economic growth).

**Debt for investment spikes**

Although the availability of debt can encourage squandering, it can also allow for some very useful spending such as public investments. Of course, some of this financing will be borne by future generations, but that is actually quite fair if they too benefit from such investment. However, this argument holds true only in the case of investment spikes: if the level of investment remains constant, future generations can also pay for past investments they use by financing investments for the generations after them.

To avoid such spikes, the pace of investment needs to be calibrated as evenly as possible. If this is not convenient, an attempt should be made to distribute their financing...
over time, not only by taking on debt but also by anticipating them and then pre-financing them by paying into a specific fund (such as the Rail Infrastructure Fund). Ideally, public investments that also benefit future generations should really be treated differently from spending that benefits current generations alone. However, it is not easy to gauge how useful specific public spending will be for future generations. Infrastructure spending obviously falls under investments. But, if we were to consider indirect impacts, many other forms of spending could be classified as investments. The debt brake does not make any exceptions for investments for fear that the imprecise definition of an investment could lead to excesses, and because investments constitute only a relatively small part of the federal budget, composed mainly of transfers.

Crowding-out of public spending

The interest due on the existing debt means that less money is available for other spending items, except, of course, if there is an increase in tax receipts due to a higher tax rate (though this would have an impact on economic growth, as we will see below) or because the tax base has increased (as a consequence of economic growth).

The following chart shows that the portion of government revenue allocated to servicing debt can vary considerably from one country to another. It is less than 4% of revenue in Switzerland, more than 11% in the United States, and more than 14% in Greece.

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2 In Switzerland, if necessary, these funds may borrow from the Federal Treasury (not subject to the debt brake) and reimburse the loan with earmarked revenue. However, creating a fund and earmarking revenue would require a new law and thus be subject to an optional referendum.
Figure 4: 2010 interest payments of various advanced economies (% of revenue)

Ricardian equivalence

For a given level of public spending, if certain assumptions are satisfied, then it makes no difference whether this spending is financed by debt or by taxes. This is the theory of Ricardian equivalence (i.e. equivalence between the options of tax or public debt), named after David Ricardo, who first raised this possibility only to subsequently reject it as being unrealistic. The idea was later reintroduced and expanded by Robert Barro.3

On the face of it, the idea seems to be somewhat eccentric. For a start, by financing spending with debt as opposed to taxes, current generations are placing the burden on future generations. Secondly, public debt leads to an increase in the interest rate, which penalises private investments. It must also be remembered, however, that private saving can be affected by public debt. Thus, public debt may result in an increase in private savings (compared with the scenario in which the same public spending is financed immediately through taxes) if taxpayers expect that public debt will merely postpone their tax burden to the future and they save their money now to meet the upcoming tax liability. In this case, financing public spending by debt rather than taxes will have the effect of increasing private saving to the extent that it exactly offsets the increase in public debt. Public borrowing thus has no impact on private investments by way of the interest rate, as this rate is not influenced by the government’s mode of financing. Neither will future generations be affected by public debt: it is true they will have to bear a heavier public debt burden, but they also inherit a higher level of private savings.

Most economists reject the thesis of Ricardian equivalence because it is based on some unrealistic assumptions such as people having the foresight to look ahead to the future taxes implied by government debt, full accounting for the impact on future generations, and the absence of obstacles to borrowing. According to Elmendorf and Mankiw (1998), empirical studies militate against the assumptions required by the theorem of Ricardian equivalence. They note, however, that it is far more difficult to prove or disprove the consequences of Ricardian equivalence (on consumer spending, interest rates,

3 His original paper dates from 1974. See Barro (1996) for a more recent explanation of his ideas.
The consequences of debt

For more recent literature, see Ricciuti (2003), Briotti (2005) and Aisen and Hauner (2008).

Barr (1996) says: “In this respect, the role of the Ricardian equivalence theorem in public finance is analogous to that of the Modigliani-Miller (1958) theorem in corporate finance. In each case, the assumptions of the theorems are frequently thought to be unrealistic, but the recognition of the constraints of the theorem force analyses into internally consistent, productive modes.” See also DeLong (2012).

exchange rates and the current account). One problem lies in the fact that these consequences depend on expectations that are themselves difficult to observe. They conclude that “the empirical literature examining the effects of fiscal policy on consumption, interest rates and international variables fails to offer clear evidence either for or against the Ricardian hypothesis. If the evidence is so weak, why then do most economists feel confident in rejecting Ricardian equivalence as a description of the world? The answer, we believe, is that most economists are incredulous about the assumptions that are needed to support the Ricardian view of government debt.” Seater (1993), on the other hand, argues in favour of Ricardian equivalence: “When attention is restricted to the more methodologically sound studies, it is difficult to find statistically significant effects of debt, suggesting that Ricardian equivalence holds approximately”.4

Even if Ricardian equivalence is not an accurate description of reality (even at first approximation), it is an approach that may be useful. As Elmendorf and Mankiw (1998) point out, “even if Ricardian equivalence does not describe the world, it can be viewed as one natural starting point in the theoretical analysis of government debt […] trying to explain why Ricardian equivalence is not true can yield a deeper understanding about the effects of government debt on the economy”.5

If the thesis of Ricardian equivalence held true, this would mean that a tax cut would fail to stimulate an economy in recession as the entire tax cut would be saved. However, this says nothing about the stabilising impact of an increase in spending, as the concept of Ricardian equivalence is based on a given spending level.

Ricardian equivalence challenges the idea that it makes a difference whether public spending is financed by taxes or by debt, but it does not

4 For more recent literature, see Ricciuti (2003), Briotti (2005) and Aisen and Hauner (2008).

5 Barro (1996) says: “In this respect, the role of the Ricardian equivalence theorem in public finance is analogous to that of the Modigliani-Miller (1958) theorem in corporate finance. In each case, the assumptions of the theorems are frequently thought to be unrealistic, but the recognition of the constraints of the theorem force analyses into internally consistent, productive modes.” See also DeLong (2012).
challenge the idea that changing public spending makes a difference. We might well wonder whether a theory analogous to that of Ricardian equivalence could apply to spending, claiming that, if certain conditions are met, an increase in debt-fuelled public spending will be cancelled out by an increase in private saving, leaving aggregate demand unchanged. Imagine, for example, if the government increased its spending levels permanently, taxpayers could conclude that the government will have to tax them sooner or later to finance such new spending and that, as a result, they will have less disposable income in the future. They may then decide to smooth their private consumption over time by immediately lowering consumer spending (and thus increasing savings) by the same amount as the increase in public spending.\footnote{The situation is more complex if there is a change in taxpayers’ income (e.g. if they change the number of hours they work).} For a temporary increase in public spending, Krugman (2011c) notes that even if we assume that the assumptions of Ricardian equivalence are right, there is no reason to expect taxpayers to immediately offset the entire increase in public spending. For the time being, a temporary increase in public spending would be only partially offset by a reduction in private consumption.

3.2 Growth

This section looks at the different channels through which debt can affect growth, in particular: a rise in interest rates (crowding out private investment), distortions caused by taxes levied in order to service debt, public investments, stimulating the economy by boosting demand, and effects in the opposite direction (e.g. via investor confidence). The issue of the impact of debt on growth has spawned much debate in academic circles and in international organisations. It is a difficult empirical issue, as it entails more than simply observing a correlation. The direction of causation must also be assessed (to what extent are we observing the impact of debt on growth as opposed to that of growth on debt?) and the other factors influencing growth also need to be taken into consideration.
The consequences of debt

Interest rate (crowding-out of private investment)

Public debt can have the effect of crowding out private debt by increasing the interest rate, thereby penalising investments and stifling growth. This effect is mitigated to the extent that foreign investors are prepared to finance this public debt, but this will mean having to pay interest abroad, which could be problematic for a country that (unlike Switzerland) cannot easily maintain a current account surplus. The effect is also lessened in times of recession, when uncertainty surrounding the future tends to discourage private investment in any case, and interest rates (apart from the risk premium) are low.

If the theory of Ricardian equivalence (see the Box on page 18) were correct, this would mean that the interest rate would remain unchanged following a tax cut offset by an increase in borrowing (for a given level of public spending) as the increase in public debt would be offset by an increase in private saving. However, a temporary change in debt-financed public spending could have an impact on the interest rate. Debt could also have an impact through other channels, such as encouraging squandering, as previously mentioned.

Tax rate

The interest burden rises along with debt (all other factors being equal). In principle, the taxes needed to pay this interest have an adverse effect on growth (the extent of which depends on the type of tax), as taxes tend to discourage both labour and investment.

If spending (excluding interest payments) is independent of the means of financing, then issuing debt simply postpones the tax burden required to cover such spending to the future. If spending was financed by taxes levied straight away, this would also have stifled growth. The argument that the taxes levied in order to pay interest hamper growth should be viewed in light of the fact that, in any case, this spending would have to be financed by taxes at some time or another, at which point it would also have the effect of hampering growth. It is
generally considered that the impact of taxes on growth is non-linear: the negative impact on growth increases disproportionately faster than the tax rate. This is why it is preferable to avoid tax spikes. By allowing tax smoothing over time, debt helps to reduce the overall impact on growth of a spending spike (e.g. an investment spike for infrastructure).

A country could also issue debt in order to pay its interest. In this case, issuing debt does not merely postpone the tax burden required to cover the spending in question but completely avoids it, as even the interest is not financed by tax. Such a strategy is generally not sustainable: the debt explodes and, ultimately, investors refuse to lend.\textsuperscript{7}

\textit{Public investments}

Public debt has a favourable impact on growth if the money raised is used to finance public investments that subsequently support growth, such as investments in infrastructure, training and research. In turn, this higher growth makes it easier to service the debt. In contrast, an austerity policy may have a lasting negative impact on growth if budgetary cuts are made to spending that would otherwise contribute to growth.

\textit{Keynesian stimulus of the economy}

In times of crisis, when certain factors of production are not used on account of a cyclical downturn in aggregate demand, an expansionary fiscal stance can, in principle, reduce the wastage of these unused resources and boost the economy. This is the Keynesian approach to stimulating demand through fiscal policy. The devil is in the detail, however, and debates about changing the fiscal stance take time. This makes it difficult to implement discretionary measures in a timely manner, which is why policymakers generally tend to prefer to merely let the automatic stabilisers operate freely: the automatic change in receipts and certain expenditure items (e.g. unemployment benefits) immediately contri-

\textsuperscript{7} This strategy may work as long as the interest rate is lower than the rate of economic growth. However, this presumes that the debt ratio remains low (otherwise, there will be an increase in the risk premium and therefore the interest rate) and that the rate of economic growth remains high. Once the interest rate rises above the rate of economic growth, this strategy no longer works. When this strategy works, issuing debt has no impact on growth via the tax rate but it could by way of other channels (crowding-out of private investment).
The consequences of debt

butes to stabilising the economy. The use of discretionary measures in fiscal policy should be limited to exceptionally serious crisis situations (in which case, the amount and the structure of such measures are also issues that need to be considered). Here, the extent of the crisis accelerates the policy process, and the crisis may be sufficient for the measures decided upon to be implemented in time. The problem of the delays is also less significant if the crisis can be forecasted sufficiently far in advance. Irrespective of whether policymakers opt for automatic stabilisers or discretionary measures, the more open the economy, the lower the impact. This is because by stimulating imports, an expansionary fiscal policy loses some of its impact on the domestic economy. If the crisis is international, and all countries have expansionary fiscal policies, the losses due to imports may be offset by exports benefiting from an expansionary fiscal policy implemented abroad. In any case, the use of debt for stabilising the economy must be implemented consistently over the business cycle, i.e. debt should be reduced when the economy is booming (as foreseen by the Swiss debt brake, for example). This is the second advantage of automatic stabilisers: they also operate freely in times of economic growth (with a favourable impact on debt). In such boom times, it is politically difficult to implement restrictive discretionary measures that would offset the impact on debt of expansionary discretionary measures taken during times of recession.

Non-Keynesian effects

There may be channels through which the impact of debt on growth is opposite to that of the Keynesian effect. There are two main categories of such “non-Keynesian effects” (see Briotti, 2005):

• **Confidence**
  When a country is highly indebted, investors may worry about instability, e.g. a tax hike, inflation or the risk of sovereign default. This may adversely affect investments and therefore growth. An austerity policy may help to restore confidence. Moreover, confidence in the government’s ability to manage its budget may encourage households to spend more rather than increase precautionary saving. The extent of such effects depends on the situation in which the country finds itself. In the current circumstances, there are many who do not believe that such effects play a key role.
example, when Standard & Poor’s downgraded France’s credit rating (from AAA to AA+) in January 2012, they said: “We believe that a reform process based on a pillar of fiscal austerity alone risks becoming self-defeating, as domestic demand falls in line with consumers’ rising concerns about job security and disposable incomes, eroding national tax revenues.” (Standard & Poor’s, 2012).

- Wages
  An austerity policy based on public-sector wage cuts has the effect of lowering wages throughout the economy, which increases profits and boosts investment.

What does the empirical literature say about the impact of a change in the debt level?

When assessing the short-term consequences of fiscal austerity on growth in times of crisis, we need to look at the impact of both the Keynesian effects (“austerity is pernicious”) as well as non-Keynesian effects (austerity by spending cuts actually promotes growth, even in the short run). The question is: which channel will dominate? Economists tend to take sides: there are those who believe the non-Keynesian effects will dominate and those who believe, on the contrary, that the Keynesian effects will dominate.8

Proponents of the former view, of whom Alberto Alesina is perhaps the best known, claim that expenditure-based adjustment (as opposed to a tax-based adjustment) tends to increase growth even in the short run. In fact, Alesina and his co-authors are somewhat more circumspect in their findings, at least in recent years, as for example in Alesina and Ardagna (2010): “In fact, we uncover several episodes in which spending cuts adopted to reduce deficits have been associated with economic expansions rather than recessions.”

Economists on the other side of the fence, despite broad consensus on the significant long-term beneficial impact on growth of reducing debt, do not agree on the short-term benefits of fiscal austerity. The IMF rejects the ideas propounded by Alesina and his co-authors, coming instead to the conclusion that (IMF, 2010): “Fiscal consolidation typically

8 This topic is debated on the Vox website of the Centre for Economic Policy Research (and is treated in their recent ebook “Austerity: Too Much of a Good Thing?”)
The consequences of debt reduces output and raises unemployment in the short term. At the same time, interest rate cuts, a fall in the value of the currency, and a rise in net exports usually soften the contractionary impact. “Specifically, the IMF believes that fiscal consolidation equivalent to 1 % of GDP leads on average to a 0.62 % decline in GDP after two years. Perotti (2011) presents four case studies in which austerity was associated with an expansion and highlights the role played by a decline in interest rates and currency depreciation. He concludes that even if austerity is sometimes associated with an expansion, this is probably not going to be the case in eurozone countries in the present circumstances, where depreciation is not an option (moreover, if austerity is implemented in several countries simultaneously, this also limits the possibility of export-led growth), and interest rates (excluding the risk premium) are already low. This is in keeping with the thinking of Krugman (2010): “There have been historical cases of spending cuts and tax increases followed by economic growth. But as far as I can tell, every one of those examples proves, on closer examination, to be a case in which the negative effects of austerity were offset by other factors, factors not likely to be relevant today.”

What does the empirical literature say about the impact of the debt level?

There is a long history of literature on the impact of the debt level on growth in emerging economies. The best-known paper, which also covers industrialised countries, is probably that of Reinhart and Rogoff (2010a). They find that the link between debt and growth is particularly strong when public debt reaches a threshold of 90 % of GDP and does not exist for lower debt levels. Although written by well-respected authors, this paper has nonetheless been criticised, for example by Nobel economics laureate Paul Krugman9 and particularly by Bivens and Irons (2010). Reinhart and Rogoff (2010b) have tried to respond to the objections raised.

The main objections are as follows:

• Correlation rather than causation
The main objection is that Reinhart and Rogoff (2010a) find a correlation between a high debt

9 See the following articles in his blog: Notes on Rogoff (wonkish) (21.7.2010), High-debt history (23.7.2010), Japanese Debt And Growth (28.7.2010), Reinhart and Rogoff are confusing me (11.8.2010), Debt and Growth in the G7 (26.12.2011).
level and low growth but do not demonstrate that it is the high debt level that causes low growth. Low growth could well cause an increase in debt. For instance, this is probably what happened in Japan, and also to a certain extent in Switzerland, during the 1990s. Reinhart and Rogoff (2010a) give no proof of causation. They merely state that a high level of public debt may produce a debt crisis (the increase in interest rate risk premia forces a government to reduce debt) which then impacts on growth (as in the case of Greece). This channel is not directly an impact of debt on growth but of the debt reduction that may become necessary when debt is too high (see Chapter 5, which deals with the consequences of reducing excessive debt). Above all, this statement does not change the fact that the empirical studies carried out by Reinhart and Rogoff (2010a) do not prove causation.

- **The threshold of 90% of GDP is relatively arbitrary**
  Reinhart and Rogoff (2010a) arbitrarily divide countries into four categories: those with debt below 30% of GDP, between 30% and 60%, between 60% and 90%, and above 90% of GDP. They find that economic growth is weaker in the last category. However, this 90% threshold stems from their own classification, which itself is arbitrary. If they had considered classes between 70% and 100% of GDP and then over 100%, they may well have found that the threshold stood at 100%.
  Reinhart and Rogoff (2010b) respond by saying that debt is rarely higher than 90% of GDP. This happens in only 8% of their observations. If they had considered only debt rates higher than 90%, they would have had too few observations (only 2% of the observations had debt in excess of 120% of GDP). They argue that if such high debt levels were harmless, they would have had more of them in their
observations, with policymakers availing of the possibility of obtaining debt at this level.

- **Particular post-war effect**
  The fall in GDP growth in English-speaking countries in the years immediately following World War II may also be explained by the withdrawal from the workforce of women who had worked outside of the home and thus contributed to GDP during the war.

There are also other studies on the impact of public debt on growth. Kumar and Woo (2010), for example, find that debt has an impact on subsequent growth, even taking account of other factors that also influence growth. Mehmet et al. (2010) use econometric methods to estimate the threshold. They find that when debt durably exceeds a tipping point of 77% of GDP, the impact on long-term growth turns negative (and is positive as long as debt remains lower than 77% of GDP). Cecchetti et al. (2011) set the threshold at 85% of GDP. For Checherita and Rother (2010), the threshold is around 90–100% of GDP. Thus, various authors find that debt has a negative impact on growth once it reaches a threshold level of between 70% and 100% of GDP.

### 3.3 Redistribution: what burden is transferred to future generations?

Issuing debt entails a burden transfer to future generations. From the point of view of the public budget, the debt burden takes the form of interest payable to bondholders. Evaluating the debt burden in macro-economic terms is more complex. To the extent that government bonds are held by residents of the same country, the debt is owed by that country to itself, i.e. at first glance this has no effect on the country’s aggregate wealth. This is the basis for the argument that it is not so much a case of leaving our children a debt burden but the promise that some of our children will pay interest to some of our other children (in return for the postponed consumer spending implied by the holding of bonds). The burden of the debt transferred to future generations is neither the amount of the debt nor the interest payable, but rather the indirect costs, comprising a number of different components. Firstly, servicing the debt may conflict with the government’s objective of intra-generational redistribution, as
taxpayers will be paying interest to sovereign-bond holders who are likely to be wealthier than the average taxpayer. Secondly, servicing the debt entails certain disadvantages we have already mentioned. It may lead to cuts in other public spending and thereby thwart the very objectives that this spending was supposed to attain. Servicing the debt may also force the government to raise taxes, which leads to an intergenerational transfer of the associated distortions.

To the extent that public debt is held by non-residents, the payment of interest constitutes a transfer from that country to another. This effect may be cancelled out by opposite flows of interest paid by foreign governments to residents holding bonds of those countries. It is therefore the net effect that should be taken into consideration. Insofar as public debt is held by non-residents, it directly causes an intergenerational redistribution: future generations pay to other countries part of the bill run up by the generations who issued the debt.

Intergenerational redistribution may be justified if debt is used to finance investments that will also be of use to future generations. As we have already pointed out, however, this argument holds true only in the case of investment spikes: if the level of investment remains constant, future generations may also pay for past investments they use by financing investments for the generations after them.

If technological progress makes future generations wealthier than the present generations, this may be an argument in favour of intergenerational redistribution that benefits the present generations. Certain points need to be remembered, however. Firstly, parents are likely to want their children to enjoy a better quality of life than they themselves had. Secondly, future generations cannot join in the debate to say whether or not they agree to such redistribution. Thirdly, it is to be feared that future generations will have to face challenges with regard to pollution and a scarcity of resources: although technology will evolve, there is a risk that services we can continue to take freely from nature will decrease. Lastly, we have to consider the uncertainty surrounding the future and make sure we are in a position to address it.

Debt is only one element of intergenerational redistribution. We also need to take account of the public securities (bonds) left to future
generations and public investments, as well as other elements regarding natural resources, for example. The intergenerational redistribution of debt is reduced if this debt is used to build or preserve other elements that will be left to future generations.

3.4 Current account

If a country borrows from other countries, servicing the public debt entails a transfer of resources abroad. As already mentioned, this has an impact on intergenerational redistribution. If the country has to repay its debt one day, it will have to run a current account surplus. The country may not be able to do that. In anticipation of such a situation, investors may demand a high risk premium, thereby aggravating both the current account imbalance and the debt burden. This is not a problem faced by Switzerland, which posts a large current account surplus (14.2% of GDP in 2010). The currency in which debt is issued also plays an important role: the debt burden may increase substantially if it is denominated in a foreign currency and the domestic currency then depreciates.

3.5 Risk of default

The consequences of accumulating public debt are particularly disastrous if a government is no longer capable of servicing its debt. A sovereign default can result in a financial crisis, particularly if it leads to the bankruptcy of certain systemically important debtors (particularly major banks holding large amounts of the defaulting government's bonds). When a country defaults on its payments, this can also have repercussions on other countries, as it leads to the failure of systemically important banks abroad, whose governments then have to bail them out, either because investors do not want to lend to other countries they (rightly or wrongly) consider too similar to that country or because investors become more risk-averse.

A country whose debt was previously thought to be sustainable can suddenly find itself in difficulty after a shock such as the failure of a big bank. Also, a country's downgrading by a rating agency may lead investors to sell (or even to be forced to sell) bonds issued by that country.
In theory, a country can also fall victim to a self-fulfilling prophecy if investors change their expectations, whether or not this is even borne out by the fundamentals: investors who have lost confidence in a country refuse to buy its bonds or will do so only with a high risk premium that the country cannot afford, despite the fact that the country could perfectly well service its debt if investors were sufficiently confident of its solvability not to demand a high risk premium. It is unlikely that investors would actually join forces to intentionally attack a country with sound finances. However, if bitten by a bad experience in one country, investors may well withdraw from all neighbouring countries without even checking whether these are fundamentally risky. The reality is that such countries indeed often have certain problems hitherto unnoticed by investors. The likelihood of the Swiss government suffering such a self-fulfilling prophecy seems quite slim.

The probability and the consequences of a country defaulting depend on its debt ratio, the structure of its debt and its credibility on the basis of past behaviour (see Ostry et al., 2010). Countries with the highest levels of debt are not necessarily those the markets are most worried about. Other factors also need to be taken into consideration, such as the deficit (is debt increasing over time?), economic growth (which lowers the debt ratio by increasing GDP), government-held assets (which reduce net debt), the term structure of the debt (with short-term bonds posing a higher risk, requiring frequent refinancing), the currency in which the bond is denominated (if it is in the domestic currency and if the central bank is not independent, the government may instruct it to monetise the debt and thereby avert an explicit default)\textsuperscript{10} and the bondholders’ place of residence (it is easier for a country to manage a debt it owes to its own residents and there is less incentive to default).

3.6 Other

Government debt also presents other advantages, such as the issuing of (in

\textsuperscript{10} If a sovereign bond is denominated in the domestic currency, the explicit risk of default is lower as the country can service the debt by creating money (which, however, involves the risk of creating inflation). In this case, the currency tends to depreciate, which is detrimental for bondholders living abroad, but the country is not in default. This is not possible in Switzerland, however (see below).
principle) safe securities, which are of use to private investors, particularly pension funds. Moreover, investors ask for less interest on bonds if they know they can easily sell them again. This presumes the existence of a market that is sufficiently liquid and deep, which is not the case if the amount of debt is too low. Also, insofar as they are “risk-free”, government bonds serve as a benchmark for pricing loans and derivatives in the private sector. This does not justify a high level of debt, however.
The advantage of reducing excessive debt is that it also tends to diminish the – generally negative – consequences of debt described above. However, the various means of reducing excessive debt\textsuperscript{11} tend to have undesirable side-effects, which we outline here. This is why we will conclude that prevention is better than cure.

4.1 Spending cuts and tax hikes

We have already discussed the harmful impact that austerity measures have on growth in the short term. An austerity policy typically creates conflicts. Differences can arise in determining the timing and distribution of the sacrifices to be made. When a country has so much debt that it has lost investors’ confidence, it has no alternative but to apply austerity measures straight away, even if the crisis would justify an expansionary policy. If the problem is less serious, and the government has sufficient credibility, it may be sufficient to announce a future policy of austerity, to be put into practice once the crisis has abated.

Such an announcement alone may be sufficient to have a positive impact on expectations. It is also possible to adopt reform measures straight away that will only produce substantial results in the long run, such as reforms of old-age pensions or a VAT increase to come into effect a few years later (this will allow the country to increase its receipts while at the same time encouraging consumer spending sooner rather than later so as to avoid the VAT increase, thereby reinforcing demand and stimulating an economy in crisis).\textsuperscript{12} Conflicts may also arise in determining the extent and composition of such austerity measures. The idea is to combine spending and revenue measures in such a way that will create a fiscal surplus or reduce deficits with as little negative impact as possible on growth, while remaining socially acceptable. There is a general consensus that expenditure-driven consolidation has a more favourable impact on long-term growth than tax increases, but it also depends on which types of spending are cut and which taxes are increased. In principle, a reduction in

\textsuperscript{11}Remember that it is not easy to define a threshold level at which debt is no longer sustainable, particularly as this does not depend only on the level of debt. Neither is it clear what the optimum level of debt might be.

\textsuperscript{12}Romer (2012) gives some examples of countries that adopted reforms to be realised at a later stage and which did actually realise these when the time came.
public investment will penalise growth more than a reduction in current spending. Also, some forms of taxation have a greater distortionary effect than others. According to Johansson et al. (2008), indirect taxes (such as VAT) or property taxes are less distortionary than progressive taxes on the income of natural persons or corporate taxes. An energy tax that internalizes externalities may even reduce distortions rather than increase them.

4.2 Growth

Growth tends to reduce the debt ratio. Structural reforms can stimulate the economy, e.g. by eliminating barriers to competition or liberalising the labour market. However, the rate of growth depends on several factors that are not determined by the government. A crisis period may make certain structural reforms possible that could not have been previously envisaged. However, weak demand is not conducive to investing in new sectors. Moreover, in the short term, structural reforms can raise unemployment by increasing productivity at a time of limited demand. Poorly oriented growth can also have adverse effects with regard to the environment or the sustainable use of resources.

4.3 Sale of assets

The government can also choose to sell assets to repay part of its debt. However, this will reduce future receipts (if the assets in question were revenue-generating for the government) or give rise to additional spending (if the government subsequently has to pay for services rendered through these assets). For example, selling the buildings that civil servants work in would enable the government to reduce its (gross) debt but would also mean having to pay rent in the future. This may be useful during a liquidity crisis, but this is generally not the case in a solvability crisis (unless these assets will be more productive once they are privatised). This transaction does not reduce net debt (gross debt less assets); in fact, it increases net debt if the assets are precipitously sold at a loss.

4.4 Debt monetisation and inflation

During the present crisis, the central bank in many industrialised countries contributed directly or indirectly to financing public debt. There are very few calls to increase inflation explicitly for the sole purpose of reducing real public debt; there are, however, proposals to raise inflation for other
purposes, and this would also have an impact on public debt. Other possible reasons to raise the inflation target would be to prevent certain parts of a monetary zone (e.g. Greece) from having to lower their nominal wages and prices in order to remain competitive in relation to other parts of the monetary zone (Krugman, 2011a), to increase the scope of monetary policy to reduce real interest rates before reaching the zero nominal interest rate bound (Blanchard et al., 2010), to attain a negative real interest rate even if the nominal interest rate cannot be negative (Krugman, 2000), to reduce both public and private debt burdens (Krugman, 2011b), and to facilitate the reduction in the real value of residential real estate in an over-priced market (Rogoff, 2008).

There are two ways in which the central bank can intervene:

- **Debt monetisation**
  The central bank can buy up part of the public debt (beyond a level justified by its monetary policy) with a view to helping to finance the government budget. If it is not permitted to buy public debt itself on the primary market, it can give investors an incentive to buy public debt on the primary market by buying it on the secondary market or by supplying liquidity to them on favourable terms.

- **Inflation**
  The central bank can generate inflation so as to reduce the real value of the public debt (assuming the detrimental consequences of price instability). However, it is not certain that the government immediately benefits from this inflation. A study we conducted in 2005 showed that an inflationary shock could actually produce a long-term gain for the Swiss federal government but, in the meantime, during a long period of time, made it more difficult to fulfil the debt brake requirements (Bruchez et al., 2005). This was due to the fact that some of the larger receipts are not indexed to inflation (e.g. mineral oil tax), while spending tends to be more often indexed (thus, interest payment expenditure typically saw a disproportionately high increase). Therefore, with receipts increasing less than expenditure, the debt brake rule requires fiscal consolidation. Switzerland’s situation may seem highly specific given the country’s debt brake. However, a country that cannot borrow finds itself in a similar situation, as it can no longer run...
up deficits.\textsuperscript{13} If the country can borrow, the temporarily negative impact that an inflationary shock may have on public finances is of little significance, as the government can borrow to finance these, and the long-term impact of the inflationary shock is favourable for the public accounts.

Of course, these two approaches can also be combined: by monetising debt, i.e. buying debt with the new money issued, the central bank can also generate inflation, which will reduce the real value of the public debt.

There is no question of the government putting pressure on the central bank in a country like Switzerland, where the central bank is independent. Jordan (2011), however, stresses the importance of maintaining sound public finances, as the central bank’s formal independence is a necessary though not sufficient condition for the continued success of monetary policy: “On several occasions in the past and during the current financial crisis, central banks – despite their statutory independence – have had to contribute to state financing or implement quasi-fiscal policy measures either under political pressure or after weighing up all the relevant factors”. The term “quasi-fiscal policy” refers to measures implemented by the central bank that are transfers in nature (not offset by other transfers) and are thus a matter

\textsuperscript{13} For the sake of simplification, let us take a country whose accounts are initially balanced. Suddenly, an unexpected and permanent inflationary shock occurs. Suppose that receipts and expenditure, except for interest payment expenditure, are perfectly indexed to inflation during an initial period. The accounts will run into the red because the interest payment expenditure is increasing disproportionately while all other receipts and expenditure are increasing in proportion to inflation. The disproportionate increase in interest payment expenditure can be illustrated as follows: if the interest was 2\% prior to the shock and rises to 3\% after an inflationary shock of one percentage point, the interest payment expenditure increases by 50\%, which is a lot more than inflation. In reality, the interest rate will increase by one percentage point only on new loans. But unless the need for refinancing is very low, the increase in interest payment expenditure will remain disproportionately high. To complete the analysis of the impact of inflation on a government’s public finances, the way in which receipts and other public expenditure depend on inflation would have to be examined (there is not necessarily perfect indexation).
for fiscal policy rather than monetary policy. Mackenzie and Stella (1996) define quasi-fiscal activities as follows: “an operation or measure carried out by a central bank or other PFI [public financial institution] with an effect that can, in principle, be duplicated by budgetary measures in the form of an explicit tax, subsidy, or direct expenditure and that has or may have an impact on the financial operations of the central bank or other PFIs”. For example, when a central bank furnishes liquidity to a bank that is not only illiquid but also insolvable, this is classified as a quasi-fiscal intervention.14

4.5 Default, debt restructuring and financial repression

Unexpected inflation is not the only way to pass on some of the debt burden to creditors. For example, the government can default on its payments. As a disorderly default typically has serious economic repercussions, a government may seek voluntary debt restructuring (debt reduction) from its investors. As shown by the case of Greece, whether or not such restructuring is actually voluntary is a matter for debate, with a fine line between truly voluntary and explicitly forced. At its most extreme, force may take the form of financial repression designed to make investors lend to the government at a low interest rate.15

14 It may not be easy to determine whether a bank is insolvent or merely illiquid. This illustrates the difficulty in defining the limits of quasi-fiscal intervention.

15 The government may, for example, force certain investors (such as pension funds or banks) to hold sovereign bonds. This may be quite legitimate on prudential grounds. However, it may also go beyond what is legitimate and seek only to channel funds to the government. This is what is known as “financial repression”, a series of measures that serve to restrict lending abroad (the dangers of which have already been mentioned) but which also have certain disadvantages, such as undermining the domestic financial system in the case of default. According to Reinhart and Sbrancia (2011): “Financial repression includes directed lending to government by captive domestic audiences (such as pension funds), explicit or implicit caps on interest rates, regulation of cross-border capital movements, and (generally) a tighter connection between government and banks. In the heavily regulated financial markets of the Bretton Woods system, several restrictions facilitated a sharp and rapid reduction in public debt/GDP ratios from the late 1940s to the 1970s.”
Whether it is voluntary or forced, passing on the debt burden to creditors may have disastrous consequences for the government’s credibility and, by way of contagion, may cause investors to question the solvability of other countries that – whether rightly or wrongly – are perceived to be in a similar situation.

4.6 External support

As seen in the context of the current eurozone crisis, another option may be to seek support from other countries (or from international organisations). Such support is usually subject to strict conditions and sometimes meets with strong political opposition in the beneficiary country. A distinction should be made between liquidity support and support in the face of default. Temporarily assuming some of the debt at the market rate will not ultimately reduce the debt. The eurozone countries came to the aid of peripheral countries like Greece by offering interest rates lower than the market rate. This is a relatively unobtrusive way of assuming a country’s debt; in the most extreme case, the debt is explicitly transferred, which is equivalent to setting the interest rate at zero for an infinite period. If Greece does not repay its debt to the eurozone countries, its debt burden will be more explicitly transferred. When the IMF intervenes to support a country, its loan is virtually always repaid (IMF loans take seniority). This is thus liquidity, not solvability, support. External support undoubtedly helps a country, but when it takes seniority, it has the effect of placing private holders of government bonds in a junior position, and this is certainly not an incentive to invest in such bonds.
5 Managing the institutional bias towards debt financing

5.1 Institutional bias

There are various forms of bias in favour of deficits. Politicians and public bodies may have various reasons (such as staying in power, forming alliances or gaining prestige) for spending more than the electorate actually wants to spend. And if they cannot secure the necessary budgetary resources, this will lead to deficits. There may be a lack of coordination, resulting in a race to take advantage of the availability of debt, despite the fact that the individual decision-makers would probably be prepared to limit their debt if everyone else agreed to the same. Politicians may limit their time horizon to the duration of their mandate, with the result that they are less willing to consider the long-term adverse effects of debt. They may adopt a debt strategy that will enhance their chances of re-election (if the debt is not clearly visible) or limit the fiscal scope available to the next government (if they are not re-elected). Some may want to increase public debt so as to increase spending (in the hope that receipts will also increase in time), whereas others may want to increase public debt so as to cut taxes (in the hope that expenditure will also decrease in time). The difficulty in spreading out the sacrifices to be made may slow down the process of fiscal consolidation.

5.2 The safeguards in Switzerland

Institutional mechanisms can play a crucial role in combating the political biases towards excessive debt and in preventing a country from suddenly having to seek a debt-reduction plan. The crisis in the eurozone and, to a lesser extent, the recent political turmoil surrounding high debt in the US are an indication of the budgetary problems that can arise from malfunctioning institutions. The following is a brief outline of the safeguards in place in Switzerland.

With a system of semi-direct democracy, the Swiss electorate have a direct say on certain issues, for example regarding fiscal policy. This limits the extent to which elected representatives can deviate from voters’ wishes. The people decide on the raises in taxes proposed by all levels of government. At the cantonal and local level, the people can also decide about the main spending

16 For more details, see Alesina and Perotti (1995).
items (financial referendum). The interaction between direct democracy and federalism gives citizens closer oversight of local authorities’ finances. Direct democracy also encourages integration of all the main political forces into the government (because each of them is able to paralyse the government by appealing to the people). This creates relative stability of the governing forces compared with majority regimes, in which the majority can exclude the opposition from power until the next time the majority changes. Because of this relative stability, the parties are more likely to consider the long-term impact of debt.

After Switzerland’s debt exploded during a period of stagnation in the 1990s, the debt brake mechanism was introduced at the federal level (several cantons also have a fiscal rule).\(^\text{17}\) This fiscal rule aims at a medium-term balance between federal receipts and expenditure. It allows for budgetary deficits during an economic downturn and requires a surplus when the economy is booming. In more concrete terms, this rule requires that expenditure not exceed the receipts that the federal government would obtain when the economy is growing at its estimated potential rate (i.e. neither in a downturn nor in a boom). This mechanism has corrected two asymmetries that previously existed. Firstly, it was easier to increase spending than taxes (as tax hikes are typically subject to a referendum, while this is not the case for spending increases at the federal level). Secondly, it was easier to take on debt in a downturn than to produce surpluses when the economy is booming. Here too direct democracy plays a crucial role: the debt brake was passed by referendum with 85% of the votes in favour of it. As elected representatives are not permitted to repeal a rule that has been passed by the people, they are obliged to adhere to this rule (as opposed to a rule they have adopted themselves, which they may repeal whenever they wish). Of course, the debt brake does permit certain exceptions that elected representatives may be tempted to abuse. Doing so would entail a major political risk, however, given the widespread support for the debt brake among the electorate. It

\(^{17}\) The FFA has published several papers on the debt brake. For example, see Geier (2011) for a recent discussion, and Colombier (2004) for a discussion dating from the introduction of this mechanism.
should also be noted that fiscal policy is not the only economic stabilisation instrument, due to the fact that Switzerland has an independent monetary policy (unlike member states of a monetary union).

Having a debt brake in place is not enough, however: it is also important to ensure it can be put into practice without hindrance. For example, risks need to be mitigated (such as those of a financial crisis or a nuclear accident). The experience in several countries has shown how private debt can turn into public debt. Trends need to be anticipated, such as demographic ageing and rising healthcare costs. Social security funds (with the exception of the federal government’s contribution) are not subject to the debt brake, so the issue of devising specific rules for these is now a topic of much debate.¹⁸ The need to maintain sound public finances is particularly evident in light of the sovereign debt crisis in the eurozone and the various other challenges to be expected, not least the demographic challenge.

¹⁸ A rule already exists for the unemployment fund. For a discussion on the fiscal rules for social security funds, see Bruche and Matter (2011).
6 Conclusion

This paper outlines what the consequences of public debt can be. While certain measures can be taken to correct excessive debt, these tend to have negative side-effects in the short run. Prevention is better than cure, for two reasons: firstly, so that governments may avoid having to pay high risk premia (or even finding themselves in a situation where they are unable to borrow further) and the threat of political paralysis, and secondly, so as to prevent the side-effects of a fiscal consolidation that suddenly becomes necessary when debt is excessive. When such measures have to be implemented all at once and during an economic crisis – the worst possible time – their consequences are particularly hard to bear.

In Switzerland, excessive debt is largely prevented by institutional mechanisms: semi-direct democracy, federalism, political stability (resulting from semi-direct democracy) and fiscal rules. It nonetheless remains important to anticipate possible changes that could threaten public finances (e.g. demographic ageing) and to reduce the risks of disaster (e.g. default risk of a bank that is “too big to fail”). The global economy is more fragile than could have been imagined a few years ago. This in itself is another argument for keeping debt under control, so as to ensure sufficient fiscal scope in the event of a crisis.19

19 Cecchetti et al (2011) state that “to build the fiscal buffer required to address extraordinary events, governments should keep debt well below the estimated thresholds”.
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