Jan Winiecki
Member, Monetary Policy Council
of the National Bank of Poland (NBP)
and
Professor and Chair, University of Information Technology
and Management, Rzeszow, Poland

The Crisis behind Present Crises: A *Westerdaemmerung* Perspective

1. Introduction: Search for a State!

What the Frenchmen are saying, when men quarrel for no apparent reason? They say: "*Cherchez la femme!*", or: "Search for a women!", who is an object of that subterranean rivalry. What I say, when I see aberrations in the performance of the economy: "*Cherchez l'Etat!*". Why? Because business cycles, accelerations and decelerations, expansions and recessions, even exuberant, irrational optimism in expansions and no less irrational pessimism in recessions, etc. – all are a n o r m in a capitalist market economy.

However, a b e r r a t i o n s are another matter. Nine times out of ten they are the end result of state intrusions into the functioning of the economy. The moral hazard we have seen so often, has been an aggregate outcome of a number of separate public policies, both past and present. With a difference, may be, that at present the scale of the moral hazard has been much larger.

What should also be added to the foregoing, is the warning about *the operation of the law of unintended consequences*. Actions generate reactions and political intrusions may create intended consequences, but the history – not only economic history – proves that more often than not they create *un*intended consequences. Neither omniscience, nor omnipotence should be expected from human action. The following parts of the paper offer supporting evidence

A more general cautionary note is in order, however, before I begin to look at particular crises of the present. These crises (the "great financial crisis" that began in the US and the Eurozone crisis) are developments that – although costly and painful – would have been much less severe and more easily surmountable if it had not been for the fact that the West is mired in a much more important "civilizational" crisis.

The latter is an ever heavier load of public expenditures due to the welfare state obligations and a resultant ever slower economic growth that prevents Western governments effectively addressing their financial *cum* institutional challenges. For example, the simplest escape from such crises through accelerated economic growth seems impossible under the continuous pressure of *The Crisis*. I call it civilizational because of institutional and moral distortions injected by decades-long expansion of welfare Behemoth, which undermine the efficiency of institutions of the market.

2. Real Causes of America-generated "Great Financial Crisis"

2.1. How FED Creates Moral Hazard On a Gigantic Scale

Already in 2002 Robert Barro noted the propensity of the then FED Chairman, Alan Greenspan, to cut, again and again, interest rates: "*The pattern of accelerated rate cuts is worrisome because it might signal that the FED has become less committed to maintaining low inflation and more interested in attempting to forestall any economic downturn*." [Barro, 2002, p.157] and added that "... *it would be better if Greenspan remained focused on his central mission of monetary policy*" [*ibid.*, p.158]. Unfortunately, Chairman, Greenspan did not; either earlier or later. The recipe was straightforward: Russian crisis? Let's cut interest rates. *Dot.com*'s bubble? The same. Terrorist attack on 9/11? The same. No matter what had been the malady, the cure was the same: cutting deeply interest rates.

Greenspan was not alone. There were many economists, mostly (but not exclusively!) of interventionist persuasion, who were delighted by such approach to business cycle. Some of them fervently wished it would be banished forever. Consequences of drowning the economy with money in order to forestall a n y economic downturn were, however, disastrous in the end.

What it means for the economy to be drowned with money? It means for businesses and households to have a nearly unlimited access to inexpensive credit. We all remember the basic diagram from the capital theory on investment project selection. The level of interest rate offers a cut-off point, indicating which projects look profitable (at a given risk level) and therefore should be selected for financing and which should not.

But what if the interest rate tends down to near-zero as a result of intermittent deep interest rate cuts by the central bank? It means that nearly all projects look (artificially!) profitable. A r t i f i c i a l l y, because interest rate cannot be kept forever near the zero level. And yet Alan Greenspan had maintained that "*not only have individual financial institutions became less vulnerable to shocks from underlying risk factors* (sic!!)*, but also the financial system as a whole has become more resilient*" [quoted in Krugman, 2008, s.264]. Such views were not confined to America. The then Chancellor (later Prime Minister) Gordon Brown stressed that under his (interventionist) economic leadership there would be "No Return to Boom and Bust" [Simpson, 2009].

Over a long period of cheap money available, a widespread moral hazard had been emerging. *The Economist* [9.08.2008] stressed the creation of a "*speculative mentality in financial markets ... Why not take risks if you know that central banks will intervene only in falling, not rising, markets?*" [p.12]. Such sentiment was called the *Greenspan Put* around Wall Street.

Bankers, encouraged by the FED policies, indeed were taking more risks under such circumstances. With weak capital base they were indeed "running on empty" according to Anat Admati and Martin Hellwig [*The Bankers' New Clothes*, Princeton UP, 2013] with their capital base running in excess of 1:30 capital/assets ratio. Undoubtedly, hoping to be saved by the *Greenspan put*.

But pretensions of being able to banish recessions and, alongside, eliminate risk from the economy could not hold forever. With a increasing federal interest rate in response to rising inflation, many investments (including residential housing) turned out to be financially unviable. The risk, artificially reduced for the time being, returned with a vengeance. It was only a matter of time when and where some bubble will

burst. It turned out to be the housing sector and the reasons why add to our evidence of the distortionary, moral hazard-generating role of the state in the economy.
The unintended consequences of such policies, combined with other errors, had been lower lending standards. An empirical investigation by A. Maddaloni and J.-L. Peydro [Bank, Risk-taking, Securitization, Supervison and Low Interest Rates. Evidence from the Euro Area and the U.S. Lending Standards, ECB Working Paper Series No. 1248, October 2010] prove that low short-term interest rates – too low for too long – lead to lowering of lending standards. Their comparative study finds the evidence of such lower lending standards in both the US and the Eurozone countries. And they find that the more lending standards had been lowered, the larger was a negative effect on economic growth.

2.2. From Affordable Housing Policies To a Collapse of the House of Cards

The most recent housing bubble in the U.S. was supported not only by monetary policy flooding the economy with money (too low for too long central banks' interest rates). It would do a lot of damage on its own (and it did), but not that much! The bubble was also a consequence of a long trend in regulations and policies of successive American governments, which pressured private financial firms, primarily banks, to spend a part of their money on a variety of projects benefiting "disadvantaged members of the community". To offer an example, the famous (or *in*famous) Community Reinvestment Act of 1977 warned banks in no uncertain terms about negative consequences of not spending a part of their money in that manner. And spending they did on a variety of substandard loans – primarily, but not exclusively, mortgages. The political pressure increased further in early 1990s.
Consequences were, expectedly, negative, but some more harmful than other. The tying of a part of the money to low profitability/high risk loans for low or irregular income customers (sometimes called *ninja*, from: *no income, no job, no assets*) had dual effect. On the one hand, repayment level of the whole mortgage portfolio declined. On the other, banks had been forced to search for some projects of above-average profitability – and therefore more risky – in order to stay close to long term profitability levels, a classical case of perverse incentives creating moral hazard!
Under the political slogan of "affordable housing", coined during the Clinton era, banks were *de facto* forced to make substandard loans. The softening of mortgage loan standards proceeded under many guises. One was the so-called *subprime mortgages*, that is loans to the *ninja*, people who under normal rules of the game could never dream of obtaining a mortgage loan.
Another, more varied category, has been mortgages to people of low-to-moderate, but steady, income, working full time, who simply could not afford standard mortgages. The standards of these mortgages, that is 20-25% downpayment and 20-30 years repayment period, were progressively weakened. The required downpayment was shrinking over the years and other lending standards declined (as recommended by the government, stressing the need for "*flexible standards*"!). The process accelerated in the past decade and by 2006, just before the crisis, the share of standard mortgages in the US – according to varying estimates – amounted from one third to one half of the total [see, Sowell, 2009, and Wallison, 2009]. Lower standards in turn encouraged more mortgages that, again, adversely affected banks' performance (and, with a lag, economic growth).

The rapid decline of the quality of mortgages in the most recent period before the bust was also due to the intensified activities of *Fannie Mae* and *Freddie Mac.* They were two government-sponsored-enterprises (GSE) created with a mission to maintain a liquid secondary market in mortgage loans. But with a growing political appetite for reaching ever lower income levels' electorate with "progressive" housing policies, they were encouraged to expand and, apart from insuring mortgages, they were buying subprime and other substandard mortgages from originating banks in increased quantities as a part of their portfolio. When they became insolvent and were taken over by the government, their prospective losses were, then, preliminarily estimated to be between 700 billion and 1 trillion $ [see, Wallison and Calomiris, 2008]! The reality as of now has not been so dramatic, but almost $ 200 billion spent so far is bad enough.

With inflation exceeding 3% *p.a.* interest rates went up (albeit moderately, to 5.25%) and the drama began. With such a share of substandard mortgages the traditional pattern of delinquencies and foreclosures exploded. Foreclosures rarely exceeded 2% in recessions; after 2007 they went into the stratosphere.

One more type of regulation added to the problems as well, namely the *no-recourse* rule introduced in some states by local politicians. They allowed the mortgage holder to give back the keys to his house to the bank and the latter had no more claim on the holder. As banks lose up to 30% of the value of the repossessed houses, massive foreclosures undermined financial stability of many originating banks. Their losses were estimated to be around 1 trillion $ and were a major cause of the collapse of a part of the American financial sector [Sowell, 2009].

Just as in the case of monetary policy propping up the economy in slowdowns, but not restraining it in expansions, governmental regulations and policies have also been building up the level of risk in the mortgage sector. The difference was that the level of risk was built more slowly, over a long period, although with the sudden acceleration in the preceding decade. How important was the slow, but accelerating decline in mortgage-related lending standards, may be seen from the comparison between the U.S. and Canada. The latter country also suffered from deep recession, but its regulation of the housing sector was not eroded. The standard mortgage loan has still been 20% downpayment and 80% loan-to-value ratio to be repaid in the standard time span of 30 years. There is, moreover, the obligatory insurance to be taken on the loan by the borrower. The outcome (not unpredictable under the circumstances!) has been a very much lower foreclosure rate than in America.

2.3. Regulation of the Financial System And the Law of Unintended Consequences

Regulations slapped on American multinationals by the government in early 1960s had an intended consequence of controlling the outflow of capital from the U.S., with an eye on the deteriorating balance-of-payment. The intended effect was achieved to a marginal extent. However, u n i n t e n d e d consequences were enormously greater.

Multinationals, in order to be able to use their capital in a timely and flexible manner, decided not to send their dollar revenues back to the U.S., but to keep them on special dollar accounts in West European banks. At the time of strong controls on capital flows European banks decided to use dollars kept on these accounts for lending purposes. A new international financial market has been created as a result.

The so-called Eurodollar lending market very quickly exceeded in terms of the loan volume the largest Western international markets of London and New York.

However, we cannot count on much luck in all cases of unintended consequences. More often than not, unintended consequences of regulatory arrangements upset the regulated market and undermine its harmonious operation. The reasons were best summarized by Prof. Alan Meltzer. The problem of regulators (and politicians) is that they are good in thinking of restrictions and formulating relevant rules. They are much worse in thinking about the structure of incentives that the firms in a regulated sector will face as a result.

If regulations continue to strongly restrict the profitable activity, firms are going to try to circumvent the rules, without breaking them. Moreover, regulations are static, while markets are dynamic; sooner or later firms find ways to operate efficiently and profitably in the face of a given regulation [Meltzer, 2080, 2010].

The same *modus operandi* applies to many – undoubtedly well intentioned – regulations affecting the financial markets [a story is well told in Jeffrey Friedman, 2010]. The Basel I agreement had set the level of reserve capital of commercial banks for loans to and bonds from business firms at 8%. However, the urge to perfect the rules on the basis of differentiated risk of a given category of assets moved the regulators to set the reserve capital for mortgage loans at 4%. On stand alone basis that made sense; after all, the repayment ratio for mortgages have historically been markedly higher than those for businesses. But, as stressed in the preceding section, that had historically been true with respect to standard mortgages. With the flood of substandard ones, the old patterns ceased to be valid, which was not either noted or predicted in 1991, when the U.S. adopted Basel I standards.

The result of differentiated levels of reserve capital has been a shift in proportions of business-related lending vs. housing-related lending. But an even more ominous unintended consequence emerged from the Recourse Rule of 2001, amending Basel I with respect to a new class of financial assets, namely asset-backed securities. A joint regulation (by FED, FDIC, Comptroller of the Currency, and OTS) decided that commercial banks were required to keep only 2% of reserve capital with respect to bonds backed by the stream of repayment installments of one of the three classes of assets: mortgages, car loans, or credit card debt. The only requirement was that such bonds were AAA or AA rated (or were issued by GSEs).

Again, mortgage-backed securities on the surface looked like very safe papers, indeed. After all, in good old times mortgages were being repaid at worst at 98-99% rate most of the time. But the sub-prime and other substandard mortgages changed the picture materially. Therefore, by 2001, regulators could not use an excuse of ignorance with respect to an ominous trend of ever lower mortgage standards! One should conclude that, apart from traditional good intentions-reinforced *naivete*, regulators were guilty also of negligence. The latter verdict applies also to rating agencies.

With Recourse Rule 2001 requiring so low level of reserve capital, incentives for banks and other financial institutions have become overwhelming to shift activities from those requiring 8% to those requiring only 2% of reserve capital. In consequence, supply of and demand for mortgage-backed securities (MBS) increased sharply.

But it is worth noting that the already quoted paper by A. Maddaloni and J.-L. Peydro [2010] proved empirically that a combination of “too low for too long” monetary policy rate with the presence of securitization amplified negative monetary policy effects on lending standards.

There was, however, yet another problem, generating unintended consequences. The requirement of high ratings for the new type of instruments – that MBS undoubtedly were – was additionally undermined by the oligopolistic position of a small number of rating agencies in the U.S. The 1975 amendment to the SEC regulation turned three agencies (S&P, Moody, and Fitch) into a regulation-promoted oligopoly of sort.

Adam Smith had been fond of saying already in XVIII century that the spirit of a monopolist is characterized, *inter alia*, by laziness. Therefore, unsurprisingly, rating agencies did not do enough homework to recognize the varied characteristics of assets underpinning asset-backed securities and dangers resulting from eroded standards in the case of mortgages. The consequence has been a flood of carelessly researched securities: by 2008 almost 81% of all rated mortgage-backed securities held the AAA rating [J. Friedman, 2010, p.6].

This story of a string of regulations of the financial markets that – in conjunction with other policies – undermined markets' stability and efficiency could be easily continued. Yet again, none of them have done very great harm on a stand-alone basis. Taken together, they turned out to be devastatingly harmful in their impact upon the financial markets – and the economy at large.

2.4. Why the World Caught the American Disease So Fast?

It is obvious that the sheer size of the American economy influences world economy developments to a substantial extent. Next, an even larger size of the American financial sector relative to that sector elsewhere amplifies the effects of American financial developments on the world financial markets. Finally, the U.S., as the largest borrower in the world, influences the world financial markets to an even greater extent. Thus, the supply of American financial assets is highly important for buyers throughout the world.

These are very obvious statements. However, one special aspect of that phenomenon should be stressed with respect to the most recent business cycle. The very long global economic boom, strongly supported by super-expansionary FED's monetary policy additionally increased demand for financial assets. Banks throughout the world were hectically looking for suitable securities in order to invest money flowing to them in the form of deposits.

In such a climate of amplified demand for securities two American government-sponsored enterprises (GSEs), *Fannie Mae* and *Freddie Mac,* dramatically increased their presence in the world market for securities. GSEs, strange institutional beasts even by welfare state standards, take the capital endowment from the state and are allowed to borrow, that is issue securities, to finance their activities. They were present at the financial markets for decades, but it is mostly a combination of political pressure on them to support governmental housing policies combined with the dramatic growth of demand for financial assets, which created the environment in which a reckless expansion had become possible.

From the last years of the XX century until their insolvency and the takeover by the state in 2008, *Fannie Mae* and *Freddie Mac* issued securities roughly equal in volume to that of the U.S. government!! When they went broke in August 2008, they held or guaranteed together $ 1011 bill. in unpaid balance of mortgage loans [Wallison and Calomiris, 2008]. A substantial part of those were substandard mortgages. And since a large part of mortgages were rolled into packages to back

mortgage-backed securities, they created in this manner a very large volume of substandard MBS's.
How large? In 2003 *Newsweek*'s economist, R.J. Samuelson signaled that about 3000 banks held *Fannie Mae* and *Freddie Mac* "debt equal to all their capital" [8.09.2003]. Since then, with a huge acceleration in both GSEs' activity, banks' exposure increased accordingly throughout the world. Strangely enough, the disaster took place in spite of earlier assessments that the risk of default and such takeover is "*effectively zero*" [see, first of all, Stiglitz, Orszag, and Orszag, 2002].
The ease with which they tapped the financial markets to finance their (increasingly risky) activities stemmed from their GSE status. Their rating was almost at the level of the U.S. Treasury bonds. Clearly, buyers perceived the existence of some implicit government guarantee. In that, at least, they turned out to be right – to the chagrin of American taxpayers. Mixing politics with business in yet another way turned out to be as much harmful as more traditional ways of political tinkering.

3. The Eurozone Crisis

3.1. On Institutional and Policy Faultlines

A clue to the real long-term problems of the member states of the monetary union, but also those of the European Union and of the West in general, may be found in the answer to a rather simple (but rarely asked!) question: "Why the large majority of European countries is indebted to such an extent that any further increase in debt to GDP ratio generates panic reactions of the potential lenders"? The following reflections briefly point to rarely discussed Eurozone problems and then, in the next part of the paper, I shift attention to long-term fundamentals of the decreasingly financeable welfare state.
The foregoing statement does not mean that no institutional or policy errors have been made at the creation of the Eurozone – or afterwards. On the contrary, it is worth noting at the outset that the European Monetary Union (EMU) had been created in a sequence not advised by international economics' theory. In any textbook in a section devoted to economic integration one finds the sequence, where monetary integration is preceded by a fiscal one. The EMU builders decided to substitute special disciplining arrangements for the fiscal integration suggested by the theory.
But the foregoing has not been the only institutional problem of the Eurozone. Although the Stability and Growth Pact (SGP) that was to discipline fiscal behavior of member states displayed in its original shape only a moderate degree of stringency, the practice was much worse. Two examples suffice to corroborate the above evaluation.
First, stringent rules adopted at the start for future candidates to Eurozone were not applied for West European "old timers". Belgium, Italy, and with a year's lag also Greece were accepted as members even if they did not fulfill the public debt/GDP threshold criterion. The threshold has been 60%, while the debt ratio for these three countries hovered at or above the 100% GDP level.
But worse was yet to come. Germany and France, facing rather minor fiscal problems (budget deficits at 4-5% GDP range) decided to soften the SGP rules rather than go through a moderate budget-cutting procedure. They found allies and SGP rules were significantly watered down. That created a more general impression that in reality

"anything goes". The sorry record of Eurozone discipline can be deduced from Table 1.
The present is too well known to delve at any depth. It started with the discovery of doctored Greek statistics – and with actual budget deficit approaching 14%. In fact, it was not for the first time. At the turn of 1980s and 1990s Greece recorded in 1989 a record deficit amounting to almost 17% GDP. It was, then, threatened with expulsion from the European Union, but after some (rather minor) improvements the inquiry in question was closed.

Table 1

Record of Violations of the Growth and Stability Pact's Criteria

Country	Average deficit 2000-07 (in % GDP)	Years with deficit above 3% limit	Average public debt 2000-07 (in % GDP)	Years with public debt above 60% GDP
Germany	-2.2	4	63.6	7
Austria	-1.5	1	64.5	6
Belgium	-0.3	0	96.9	8
Spain	0.3	0	47.6	0
Finland	4.1	0	41.6	0
France	-2.7	3	61.8	5
Greece	-5.0	8	99.8	8
Netherlands	-0.6	1	50.5	0
Ireland	1.5	0	30.5	0
Italy	-2.9	5	106.0	8
Luxembourg	2.3	0	6.3	0
Portugal	-3.6	4	58.3	3

Source: after *La Caixa*, Monthly Report, 2010.

The idea that it is possible to borrow forever at German interest rates without German credibility (that is with much lower country ratings) has been put to a market test. The result was a panic after panic, after panic, interspersed by public announcements of solidarity with Greece, later with Portugal, etc. And, then, at a certain point, a meeting of the Eurozone leadership was announced and its results solemnly presented as the solution to the problems of Greece and Eurozone. And the story repeated itself again and again. Here the Reader may simply follow first pages of newspapers in any West European country.

3. 2. A Strange Club without Exit Rules

As stressed already, Eurozone adopted very stringent entry criteria – for newcomers. The rules of behavior, once a country was admitted to the club, were for the Eurozone member states only moderately restrictive. This was bad enough, but the curiosity lies elsewhere. EMU is the club with no exit rules. Indeed, there are no rules

telling a member that it is going to expelled due to repeated misbehavior – and how (by what procedure).
A world renown philosopher, famous for his criticism of Marxism, Prof. Leszek Kolakowski, wrote once a delightful little book called "*Conversations with the Devil*" (in Polish), which I read decades ago. In one of the short stories he considered how somebody who was accepted to Heaven as a righteous person can be treated there if he or she suddenly begun to misbehave. Should he/she be expelled? Such decision would suggest that God made a mistake in allowing him or her in. And God is infallible.
The situation is similar here. The present writer calls it a "sin of conceit". It runs like this: "*We, the high and mighty of Europe, decided that we had erected a building destinied to stay forever and we do not need to envisage any reconstruction problems*." But playing god does not mean possessing abilities usually associated with the Almighty in any religion.
Economic outcomes we have seen in the recent years. Economic growth in the post-great financial crisis period have slowed down even further to at best 1.0-1.5% annual rate, with occasional bouts of shallow recession. Unemployment in the Eurozone exceeds on the average 10%. And although exports perform relatively well, even in Eurozone laggards, the share of Eurozone, and also European Union, in world exports declined markedly. All these, as well as other ills, cannot be blamed solely on "great recession" in the West, or on the fiscal restraint-based stabilization programs of Eurozone "sinners". The problems, as signaled in the introduction, have much deeper roots, strongly associated with welfare Behemoth. Thus, next, linkages between public expenditures and growth performance and their consequences are going to be presented here.

4. The Tree and the Mistletoe: On the Unsustainability of the Welfare State in Its Present Size and Shape

4.1. The Age of an Ever Larger Share of Public Expenditures

There is a strong conviction among many believers in leftist, or more widely: collectivist, ideas that greedy bankers, or financiers (modern Shakespearean Shylocks) caused the crisis and resultant recession. Moreover, this view is shared by a majority of population in Western countries. Thus, it is the bankers, as well as other financiers, that should be blamed for the fact that Western countries suffer from large public debt, with severe adverse socio-economic consequences for their population. In fact, nothing is further from the truth!
It has rarely been perceived that the proverbial Western camel has been moving ever more slowly under the increasingly heavy load since late 1960s. As stressed in the Bank for International Settlements' annual report "*fiscal positions in many advanced economies were already on an unsustainable path before the financial crisis*" [BIS: 82nd Annual Report: 1 April 2011-31 March 2012, Basel, June 2012]. The global financial crisis has only been the proverbial last straw that broke the camel's back. Shifting from proverbs to reality, the most recent financial crisis did not d e r a i l Western economies from beneficial trends, or brought in anything radically different from the past. It might have accelerated – by about a decade – what to some observers seemed inevitable. And, I will argue, financial crisis has been generated

largely by the same damaging institutional arrangements and policies that have been observed for decades.

Let us begin, then, with the long-term trends in question, the most important among them being ever higher public (mainly social) expenditures and promises of even more expenditures on pensions, health' care, etc., in the near and more distant future. All these increases of public expenditures in relation to GDP of these countries, have been mandated, let it be noted, in the face of increasing evidence of adverse effects of higher public expenditures – and resultant higher taxes – upon economic growth. Moreover, adverse economic effects have additionally been amplified by adverse demographic trends (especially in Europe).

Back in 1960, when West Europeans had been working hard, increasing rapidly their productivity and, accordingly, being rewarded with higher incomes, public expenditures amounted to 29% GDP in 15 countries of the future European Union (before Eastern enlargement). Public expenditures increased for that group of countries to 37% GDP in 1970, to 47% in 1980 and to 50% in 1990. They increased further in 1990s, but after attempts in some EU countries to reduce the heavy burden of taxes that eroded incentives to work, earn, save, and invest, they declined slightly in some of these countries throughout the decade in question. However, they accelerated again in the first decade of the present century. Interestingly, in 10 out of 15 countries in question, the share of public expenditures in GDP increased already b e f o r e global financial crisis and accompanying recession (*i.e*. in the 2000-05 period).

Various empirical studies point to the negative impact of public expenditures on economic growth. An interesting study by Bernhard Heitger on the impact of public expenditures on economic growth (The Scope of Government and Its Impact on Economic Growth in OECD countries, Kiel Institute of World Economics, Working paper 1034, April 2001) presented evidence on negative impact of public expenditures/GDP ratio on economic growth. Analysis pursued by Haitger led him to conclude that a reduction of public expenditures by 10 percentage points would be followed by the decline in GDP growth rate to the tune of 0.5% annually.

Other empirical studies looked in greater details at the impact of public expenditures. A relatively recent European Central Bank working paper (A. Afonso and D. Furceri, *Government Size, Composition, Volatility and Economic Growth*, ECB Working Paper No. 849, January 2008) found a whole range of impacts over the 1970-2004 period. A percentage point increase in the public expenditures/GDP ratio would decrease GDP in OECD countries by 0.12% annually (0.13% for European Union countries), about twice as large an effect than found by Heitger (see above).

Various components of both revenues and expenditures were found to adversely affect economic growth rates. On the revenue side it is indirect taxes and social security contributions; on the expenditure side – government consumption and social transfers. Moreover, volatility, *i.e*. changes in the share of public revenues and expenditures, also reduced economic growth rates. Accordingly, Afonso and Furceri suggest that cuts in the components of public expenditures most harmful to GDP growth may contribute positively to fostering that growth in the post-reform period. Still more evidence may be found in a little book by A. Bergh i M. Henrekson (*Government Size and Implications for Economic Growth*, American Enterprise Institute: Washington, D.C., 2010).

While considering adverse trends in Western economies one should also point do growing indebtedness of the countries in question. This latter trend accelerated during the 1990s, for very specific reasons. The free market "counterrevolution" of the

Thatcher-Reagan era increased the resistance to further tax increases (with the then taxes being very high in any case!). However, although electorate in many Western countries resisted tax increases, a large part of these electorates still demanded more welfare benefits. Opportunistic politicians – to satisfy the unreflective electorate – began in many countries to finance public expenditures, transfers in particular, by increasing public indebtedness. An apposite comment here, is a sad reflection of the late Aaron Wildavsky, a political scientist from UCLA: "*We have seen the enemy – and they are us*…"

General government debt accelerated sharply with the advent of global financial crisis. Now, in reference to the folk legend of conscientious states coming to the rescue of greedy bankers in order to save the general public, it is worthwhile to make a few general comments. If one prefers to portray profit-making as greed, let it be. But whatever the terminological preference, one may safely assume that in a private ownership-based, profit-oriented, competitive economy profit-making or greed is a *constant*. Montesquieu stressed already in XVIII century that enlightened self-interest is in social science an equivalent of gravitation in natural science. Nothing in particular changed the level of greed in the years preceding global financial crisis!

Another, purely economic, reminder concerns the dynamics of economic growth in the years to come. Subsequent increases in public expenditures to GDP ratios reduced economic growth over time, from one decade to another. From mid-1990s to 2005 major increases in budget deficits translated themselves into higher public expenditures/GDP and debt/GDP ratios. Consequently, the same determinants stressed earlier are expected to adversely affect GDP growth rates in the future as well. The most recent – at times hysterical – fiscal expansion in response to the financial crisis, might reduce these rates to at most 1.5% (quite probably less) in the years to come.

A difference from the 1960s to the year 2000 period is that the expected slowdown is going to affect not only European continental welfare states, but also two historically (or at least since the 1979-80 period) more liberal, free market-oriented economies: United States and United Kingdom. For in the most recent period these countries joined continental Europe in fiscal profligacy (and regulatory zealotry). In the case of Britain, under the Labor government, public expenditure/GDP ratio increased between 1997 and 2006 from 40.6% to 44.3% and then shot up to 51.0% in 2010. The changes were no less dramatic in the case of the US under both Bush-junior and Obama presidencies. Between the year 2000 and 2010 the said ratio increased from 33.9% to 42.3% GDP. We do not know when and by how much, but there is no doubt that adverse consequences of accelerated increase in the share of public expenditures appear in the form of slower economic growth of the (formerly) more market-friendly Anglo-Saxon economies.

The capitalist market economies of the West can be compared to a healthy tree; the public (primarily welfare) expenditures are more like a mistletoe. Some mistletoe makes the tree more colorful. However, as there is more and more mistletoe over time, the tree begins to loose its vitality. Too little of the juices is absorbed by the tree itself. The capitalist tree in Western countries is withering away under the impact of the mistletoe. In other words, to regain its vitality (meaning: economic growth), capitalist economies require less mistletoe (smaller welfare state).

Smaller need not necessarily mean poorer. Sweden supplies the evidence here. Over the 20 years period Swedish subsequent governments reduced the public expenditures by approximately 20 percentage points of GDP. And yet, in spite of such deep cuts, Swedes are very efficient in reducing the threat of poverty to the

most vulnerable segments of the society: the differential between the share of the population threatened with poverty before and after redistribution is about the largest among Western countries.

4.2. All Other Options Seem to Have Been Closed for Western Polities and Societies

Since longer term economic growth consequences outlined above will inevitably follow, slow growth of a major part of the Western economies seems to be the inevitable outcome for this decade. And if nothing is done to cut mistletoe to size the next decade and improve efficiency of the remaining resources the next decade may even be a decade of stagnation rather than low growth.

With little incentives to work, earn, save and invest no amount of fiscal and monetary expansion may significantly accelerate economic growth [for an assessment of the underwhelming impact of fiscal stimuli, see, *i.a*., E. Ilecki, E.M. Mendoza and C. Vegh, Determinants of the size of fiscal multipliers in open economies, *No Way Out: Persistent Government Interventions in the Great Contraction*, AEI, Washington, D.C., 2013]. Thus, the highly indebted economies, handicapped by high public expenditures/GDP ratios, will not be able to "grow out of high debt levels". The foregoing, best scenario seems to be impossible to accomplish.

Next, for those who may still work under the illusion that higher taxes ("let the rich pay for the crisis!") are a viable alternative, a long series of studies pursued by Prof. Alberto Alesina from Harvard University and a wide group of his collaborators presents what – borrowing from a recent Nobel prize winner, Thomas Sargent – may be called *the unpleasant fiscal arithmetic* (see, e.g., Alberto F. Alesina and Silvia Ardagna, Large Changes in Fiscal Policy, in: *Tax Policy and the Economy*, Vol. 24, The University of Chicago Press, 2010). The pair in question studied 107 cases of large fiscal adjustments (budget deficit reductions by at least 1.5% GDP) in 21 OECD countries. Over the period of nearly 40 years, successful – that is lasting – reductions of budget deficits were based mostly on large expenditure cuts and small tax changes: respectively 85% and 15% of total adjustment. Thus, the idea that large tax increases may make it possible to avoid expenditure cuts did not succeed in the past and is unlikely to do so in the future.

There is yet another scenario that has been insistently invoked in recent years. As Western economies failed to accelerate economic growth even in the face of extremely large stimuluses (as in the US, UK or Spain) an alternative of growing out of debt is pointed at, namely inflation. This author is not convinced that it is a highly probable scenario. To register accelerating inflation, Western economies would have to accelerate economic growth first and foremost. And – for inflation to emerge and accelerate – high GDP growth would have to last for some years. As such developments seem improbable in the face of what has been stressed earlier in this paper, the waiting for inflation to emerge and reduce the real value of the public debt may turn into waiting for Godot in the Samuel Beckett's play.

As stressed earlier in the quote from the BIS annual report fiscal policies pursued so far have been unsustainable even before the great financial crisis. They are as unsustainable (or even more) now. The problem is – to quote William R. White [Credit Crises and the Shortcomings of Traditional Policy Responses, 2nd International Conference on "Monetary Stability, Sovereign Debt and Financial Stability – The New Trilemma", Reserve Bank of India, February 1-2, 2012, Mumbai]

– “how the unsustainable might be stopped?”. In this author’s view, the only way left to put public expenditures on the solid financial basis is to r e d u c e them. And these reductions will have to be substantial. There is no doubt about it. Even if a political climate is inhospitable, the reality is a tough master...

5. Conclusions on Political Implications of Cutting the Public Expenditures To Levels Not Endangering Growth Prospects of the West

Major works of traditional economic historians, as well as those representing “new economic history” with a Nobel Prize winner Douglass C. North, point out unequivocally that good, *i,e*., efficient institutions have been a rarity in human history. Various states chose as a rule bad institutions (and, let me add, within institutions chose even more often bad policies). Answers to the question why this has been the case have concentrated on the structure of incentives. The assumption has rightly been made that it is in the interest of the ruler or a ruling elite to establish institutions (rules of the game) that benefit first of all those who rule, as well as those who are the pillars of their rule. And these choices have been made in full consciousness of the fact that other institutions could create more wealth.

The problem is that although concentration on the structure of incentives has impeccable credentials in economic theory, there is ample – if not actually overwhelming – evidence from democracies around the Western world that, quite often, ruling politicians made choices that were actually injurious to t h e i r o w n important interests. More than that! The choices they made of these (bad) institutions were widely supported – by both intellectual elites and the masses.

The perception of the foregoing oft-repeated pattern led the present writer to conclude that – apart from interests – it is i d e a s that play a major role in the choice of institutions. Ideas, in turn, are shaped by human imagination concerning the way the world works. However, the ideas how the world works in reality are intertwined with other ideas on how the world s h o u l d work. It is from the clash of these two types of ideas – positive and normative – that the choices of bad ideas are often born.

This author accepts the fact that individuals put forward different answers, when asked normative questions (here, to the question how the world should work) and suggests why choices of some ideas and, accordingly, of bad institutions are made. These bad institutions are very often chosen – in preference to good institutions – because bad institutions look more attractive due to their appealing moral foundations. Institutions built on such (misleadingly) appealing moral foundations turn out to be invariably inefficient. Common, or collective, ownership is one such morally appealing foundation upon which economic institutions are built. Karl Popper called such choices the “pressure of history”.

However, the experience of the last couple of centuries proved without doubt that institutions built on common ownership are inefficient – and, wherever applied, result in economic disaster. That applies both to large-scale experiments like the late unlamented Soviet Union, and to small groups, motivated either by religion or socialist ideology. The collapse of the communist political-economic system is a well known fact. A few hundred of failed small-scale experiments on American soil from XVII to XIX century are less known, but no less convincing (see Joshua Muravchik, *Heaven on Earth. The Rise and Fall of Socialism*, Encounter Books: San Francisco, 2002).

And yet such collectivist institutions are continuously being designed, proposed, and applied. The welfare state, a subsystem of institutions within the larger political-economic system of liberal democracy and market capitalism, has been one such particular network of institutions. Modest in its original aims, the welfare state expanded beyond any reasonable limits – in blissful ignorance of its moral, psychological and, in turn, economic consequences. Ignorance is costly and, in consequence, the welfare state begins to crumble before our eyes.

This has been a long process. But, in spite of all the experience, such ideas are insistently being put forward, like that advanced in the Orwellian year of 1984 by the council of Christian churches in Australia, which recommended that Australia … adopts the socialist system. Clearly, the reverends did not see the *manes-thekel-fares* sign on the – visibly breaking down – Soviet socialism. They noticed even less the first signs of the crumbling collectivist arrangements of the Western welfare states.

And, already after the collapse of communism, crude socialist semi-dictatorship of the late Hugo Chavez had been established in Venezuela. How destructive economically such ideas are in practice may be seen from the economic mess Venezuela finds itself in – in spite of enormously large oil revenues. And an interesting twist has been added to these comments by Chavez' mentor, Fidel Castro. Ailing Cuban dictator confessed in a conversation with a Spanish journalist that today he would rather hesitate before recommending socialist economic arrangements to any country.

The detour made by this author – by looking beyond West European experience – has been made on purpose. I have no doubts that collectivist solutions w i l l b e proposed – and even attempted – in some European countries and beyond. In a more vague manner, a collectivist world order was suggested not so long ago by (now-pensioned) pope Benedict XVI. Which points out, where Catholic Church stands in the debate on the choice between individualist *vs*. collectivist economic and social institutional arrangements.

Various collectivist arrangements may be greeted with great applause by many intellectuals, as well as by large segments of many societies, seduced by the (misleading) attractiveness of moral foundations of such arrangements. British Royal Society, being a association of scientists, should have known better. And, yet, they too succumbed to the temptations of advancing the cause of morally correct (a version of politically correct) collectivist nonsense. Worse still, the social engineering they propose cannot be implemented without the totalitarian control envisaged by J.-J. Rousseau's political regime.

Clearly, the fact that similar institutions have already been tried – and found inefficient or downright destructive – does not seem to deter a new wave of "true believers". It is a typical case of hubris displayed by those who believe that they, the best and the brightest, or the most hard working and pious, will succeed, where so many other failed before.

However, reformers (should I have said tinkerers?) beware. The capitalist market economy, based on private ownership, is the foundation of Western civilization. Its civic and political freedoms are resting on the autonomy of the economic activity *vis-a-vis* the state. Tinkering with the foundation to obtain short-term economic gains may bring about unintended – but h i g h l y u n d e s i r a b l e – consequences. At this point I would also like to deliver a warning for the benefit of unreflective defenders of the welfare *status quo*, ready to rescue it by any, including undemocratic or downright despotic, means. Those who are ready to do so should

note that a totalitarian welfare state model of communism went bankrupt about a quarter of a century earlier…