

# Sovereign debt and the crisis in the Eurozone

## - Part 1 of 4

### What this text wants<sup>1</sup>

In our text “Financial Crisis 2008ff.” we tried to explain how a financial crisis such as that of summer 2008 results from the normal course of business and not from mistakes or mismanagement. Towards the end of the text we briefly touched on how states attempted to rescue the financial markets and that as a result sovereign debt itself becomes subject to the practical critique of these markets.<sup>2</sup> In the last two years these policies seem to have been successful, insofar as the financial markets have, again, started to make a profit; however, as a result of the measures taken many states have now become lodged in a debt crisis of their own, which, again, is affecting the financial industry.

In our later text “Public debt makes the state go round” we then tried to explain how modern credit money and sovereign debt are related. However, there too, questions such as how states contract debt and why, who their creditors are and why, what the relation is between the GDP (gross domestic product) and sovereign debt and what the particularities of the Eurozone are, were only very briefly touched upon or not discussed at all. In this text we attempt to fill this gap. First, we want to explain the standard and common practice of sovereign debt in general, as well as providing a critique of the most prevalent explanations for the current crisis. And secondly, we would like to consider the particularities of the crisis in the Eurozone.

### Too much sovereign debt as reason for the crisis?

One way to explain the Greek problems is to remark that Greece simply took on too much debt. In fact, sometimes newspaper articles claim that Greece has the largest amount of debt in the EU. This is de facto wrong.<sup>3</sup>

1999 2003 2007 2009 2010

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Germany 1225 1384 1579 1761 2080 UK 653 631 852 1093 1351

France 804 1003 1212 1493 1591 Greece 122 168 239 299 329

Italy 1282 1395 1602 1764 1843 Sweden 161 145 133 129 146

Euro area 4618 5218 5985 7116 7837

Table 1: Time series of gross debt in bn. Euros rounded. Source: Eurostat <http://bit.ly/Ac6ME>

Table 1 demonstrates rather vividly that Greece's gross debt is comparatively small. Moreover, sovereign debt is not the exception but the rule in capitalist states. As a tendency, the more economically successful a state is, the bigger its sovereign debt (converted into Euros the US' sovereign gross debt in 2010 amounted to about 10.000 bn.). Debt is not reduced but constantly increased. Sweden has been included in Table 1 as an example because it actually reduced its sovereign debt for some time (similar to Finland and Denmark).

Somehow the current sovereign debt crisis is related to high amounts of debt – to clarify how will be the aim of this article. Pointing to huge amounts of debt does not suffice, i.e., “This could not have possibly worked out long term anyway.” The fact that almost every state in the world is in debt and the more powerful it is the bigger the debt first of all begs the following questions: why have these states permanently contracted debt? Why is it that most of the states in the world were able to pile up their debt over such a long time without any problems? Who are the creditors and why have they readily and increasingly accommodated loans / lent money to states? As usual it makes sense before asking why this “it” does not work to do exactly the opposite: what is this “it” anyway that does not work, and how did “it” work before?

## **Why sovereign debt?**

If a state's debt becomes problematic, as is currently the case in Greece, public opinion often holds that current and former politicians have failed. They have supposedly poured money down the drain, or given out nothing but presents to the people. In short, they have not managed the state for the sake of the national economy but conducted political mismanagement. This kind of explanation for the crisis is most striking for often having been arrived at only when the state's financial difficulties already exist. It seems that the outrageous profligacy of the government, or consecutive governments, has conducted itself quietly until such a point is reached. In opposition to this way of explaining the crisis, we will provide an outline as to why the democratic state always has good reasons to draw on debt as a means of making policy. For those who are wondering who “the state” is supposed to be, perhaps the following proposition: it does not matter who is in power, be it the Tories, the Labour Party, the Liberal Democrats, ...or even the Fascists - all politicians always refer back to sovereign debt as the adequate means of funding.<sup>4</sup>

## **Sparing tax sources, such that they are more yielding in the future**

The democratic state does not organise its tasks on the basis of the means of production and workers directly at its disposal. In earlier feudal states, for comparison, this was the case: feudal lords owned serfs working for them on their land which enabled them to fund knights and castles. By contrast, the democratic state allows its own as well as foreign citizens to produce on its territory an activity whereby they earn their money. If the democratic state wants to accomplish something it simply takes money away from its citizens via taxes and buys whatever it wants from the citizens (disregarding sovereign debt for the moment). Democratic states also own (parts of)

companies, e.g., in the UK there are many private-public partnerships. In such cases, however, the state does not intend to earn money but usually keeps ploughing money into this business to keep it running in such a fashion that the products and services of this business are available for the national economy on a safe and affordable basis. If the production is viable and has the same output, the state usually privatises the business as long as there are no concerns regarding national security. In principle a democratic state's income shall be based on taxes rather than the state acting as an economic subject itself.

A democratic state does not have to earn its revenue but can decide it. A wage labourer is required to earn her money, and if she has run out of it before the end of the month she is forced to confine herself.<sup>5</sup>

A business lacking money for its next push against competitors is required to make more money or ask for credit, whereas a state has the option to simply increase taxes. To avoid a misunderstanding: the state is not free to dictate its own wealth, which is to say it is in no way the arbiter of how much wealth a society has produced; it is free only to dictate how much it will expropriate of the wealth first created by the producers in that society the point here being that the money the state wants to collect through tax revenues must actually exist. This is in some ways analogous to how anyone makes money, insofar as she too may only earn that money which has already been earned elsewhere. But there is a difference: earning is different from expropriating.

Still, many hold the belief that taxes mean some kind of exchange. They give money to the state and expect are entitled, even to get something in return. Hence, if, according to this point of view, the state's actions are disagreeable, this is a scandal, since it is the tax payer who is the state's rightful client. Politicians tend to support this perspective. If they introduce a new tax they call it e.g. "green tax" whereby the claim is made that tax collection and the state's splendid use of the taxes are directly connected. Such a connection does not exist, as was perhaps most notably expressed by Winston Churchill in 1925: "Entertainments may be taxed; public houses may be taxed; racehorses may be taxed and the yield devoted to the general revenue. But motorists are to be privileged for all time to have the whole yield of the tax on motors devoted to roads. Obviously this is all nonsense Such contentions are absurd, and constitute an outrage upon the sovereignty of Parliament and upon common sense."<sup>6</sup> The taxes the state collects belong to the state - it is that simple. Accordingly, it is up to the state alone what taxes are used for. Moreover, no-one but the state itself i.e., Parliament when deciding on the state's national budget - has the right to appropriate and direct taxes (e.g., to dedicate tobacco taxes to health care or to building roads).

A capitalist state obtains its power from its citizens' private activities and collects money from whatever income they generate. No-one knows better than the state itself that it can only take what has been produced in society, i.e., money earned by the state's residents. Hence, the more successful they are in making money, the more (financially) potent the state.

This presents a comfortable dilemma to the state: on the one hand, the more the state takes from its citizens by taxation the more it is able to accomplish, whether that be in terms of procuring advanced weaponry/technology for the military, building better infrastructure, or opening more preschools and child care facilities. On the other hand, the more taxes the state collects from its capitalists the less money they have in their pockets to be able to invest in new projects and thereby further increase society's wealth. Private business is supposed to flourish – this is, after all, what makes up the state's power. Furthermore, the more taxes the state collects from wage labourers, the more it contributes to their impoverishment, which may also affect the economy negatively as a whole.<sup>7</sup>

Debt seems to offer a direct way out of this dilemma: the state obtains financial means without burdening the businesses of its citizens. These businesses are then able to invest money to increase society's wealth. It is certainly not true that citizens are not affected by sovereign debt (see the passage on inflation later). But what is true is that the dilemma of "as little taxes as possible as the basis for as much taxes as possible" functions as a founding motive for contracting sovereign debt. No surprise this option comes to politicians' minds consistently whenever it is time for preparing the next national budget.

### **Creating new tax sources, such that they yield in the future**

The second important reason for sovereign debt is perhaps best explained by comparison with a company. If, for example, Shell wants to exploit a new oil field, then it needs to invest, say, 1 bn to build the necessary infrastructure. Now, Shell does not wait until it has earned this money from the annual profits of its already existing oil fields. Instead Shell takes out a loan and starts exploring the new oil field immediately. With that credit Shell establishes its independence from the already existing sources of revenue and even creates new ones. With these sources of revenue Shell can then pay back its loan and, on top of that, make new lasting profits at least this is the calculation.

Politicians see it quite similarly. For them credit is not the exception to the rule; it is not a one-off which follows from an inadequate source of tax revenue in the face of necessary expenditure, or from a desire to preserve (potential) tax sources. With credit they are concerned with creating the optimal conditions under which tax sources can develop.

To facilitate economic growth throughout the country, extensive and well maintained road networks are required for the transport of workers, materials, and goods; universities are needed for technical progress and the production of specialised knowledge in the workforce; child care services are also necessary so that mum and dad can go to work etc. If successful states had waited until the already existing companies on their territories were successful enough to allow the funding of a new university based on tax revenue alone, the development of the means of production and the GDP would be perhaps that of 100 years ago.

It is important to understand that this logic is a logic of speculation. Credit is used to produce future national success in competition. Whether this success shows itself or whether competing national economies are more successful, or a worldwide crisis strikes through all calculations by all states, is impossible to say a priori. So when somebody ingeniously remarks, "we lived beyond our means," then three counterpoints can be made. First, it was not "we" who took on credit but the government. Second, it was not "we" either who spent the money, but the state. And third, what about this "beyond our means"? The whole point of the investment by the state was to produce the conditions which could justify the debt and some further economic growth on top of it.

### **Less tax revenue and more responsibilities: crisis**

There remains a third reason for the democratic state incurring debt, and this concerns its utility in an economic crisis. Revenue from tax breaks away as companies no longer turn a profit and subsequently lay off their staff; this causes massive reductions in income, commercial, and VAT tax revenue. At the same time state spending is increased because there are more welfare cases in the working class, and the economy must be subsidised to prevent the destruction of entire

industries. In this sense, the banking system was indeed ‘saved’ during the financial crisis with extensive new loans. For this particular dilemma, credit, of course, presents itself as a veritable option for the beleaguered state capable of securing it.

We might conclude this point with the observation that borrowing always assumes too little money. But the question one must ask is: from what conditions and for what purposes has this lack of money arisen? We discussed three fundamental aspects of the debt of the capitalist state:

- Fall in tax revenue.
- Protection/sparing of tax revenue sources for the purposes of making them stronger in the future.
- The desire to create sources of tax revenue in the first place.[8](#)

In each economic situation – growth, stagnation, and crisis – there are good reasons for politicians to rely on sovereign debt. It is, as such, true that sovereign debt is no exception but the constant companion of bourgeois politics. The rule is an ever-growing mountain of debt.

## Greece’s debt

The immense and ever-growing mountains of debt of nation states result from normal economic calculation and not from the absence of the same by spending-addicted politicians. Nothing unusual happened in Greece before the crisis; rather the country has taken out loans in order to create the conditions for better national economic growth.

This speculation has not worked out. Greece was not one of the winners of the EU common market, but a loser. Where there is competition, there are necessarily losers. The shelves in Greece are full of German and French products. It was not Greece, or Greek entrepreneurs, but Germany and France that made those gains which Greece had hoped for in joining the EC and EU. This is one reason behind the Greek sovereign debt crisis, but it is not the principal one, as shall be discussed later.

Here we want to point out that it is too easy to disregard all economic and political calculations and to say instead that Greek politicians have simply thrown money out the window. The same pattern of behaviour would be observed in any other nation faced with similar difficulties. Were Germany, to take the strongest EU economy as an example, to slide into a debt crisis, and the public would - instead of asking for reasons – call for the blood of its politicians in the same manner as has been witnessed in Greece then democracy provides enough material for those who want to find someone to blame.

First, one would find material in (almost) any budget debate. There, the government always says it has considered all aspects carefully and found the right mix of necessary expenses, savings, tax increases and cuts, plus borrowing. The opposition, on the other hand, insists that tax money would be wasted, where it does not agree with a certain decision.

It is striking, however, that in any budgetary debate the government is also accused of saving at the wrong end – i.e., where the opposition would deem measures appropriate. In every debate the opposition accuses the government of both: wasting money and saving at the wrong end.

Second, in Germany there also exists something called the “Bundesrechnungshof,” which every year publishes a book documenting where the state has supposedly wasted money or where

construction projects, for example, ran over budget (once again). Furthermore, the fact that Germany hosted a World Cup would appear about as absurd as the 2004 Olympics in Greece in light of a debt crisis.

These hypothetical considerations are meant to emphasise that it is easy to blame politicians for failing by disregarding their considerations and justifications of the specific policy measures. It is easy to blame politicians for failing, in retrospect, if one ignores that every measure of economic policy is a speculation which inherently carries the possibility of failure in it.

## **How the mountain of debt grows and why the tax payer does not have to settle the debt**

The state borrows money by issuing bonds. For example, the British state receives 1 million and promises to pay back this amount plus interest after 5, 10 or 30 years depending on the kind of bond. Greece does the same and so does Germany.

However, when these two countries are discussed some people claim that contrary to Greece, Germany could pay back its debt all of it. Similarly, pundits warn about the burden of sovereign debt the tax payers are confronted with because they would have to pay it back.

These statements are incorrect: in 2010 Germany had an absolute level of debt - gross debt - of around 2,080 bn. Greece had 329 bn of debt. Each year, a part of this debt is redeemed. Because there are “government bonds” – i.e., state bonds – with longer maturities (durations), not all outstanding debt has to be repaid every year. Greeces current problems lie in its inability to repay those debts which are currently due. As for the claim that Germany could pay its annual debt bill from tax revenue alone: this would be impossible, as a simple comparison shows. The total tax including all extra revenues for 2009 totalled at 260 bn in Germany. In the year 2010 Germany had to spend 276 bn just to repay its outstanding debt.

Greece, Germany, and the U.S. would all be unable to settle their debts through taxes. The burden on the taxpayers is definitely not that they have to pay back the debt. Sovereign debt only works so long as states can find new investors who will lend them money that can be used to pay off previous investors. This happens in one of two ways: either, a creditor gets his money back, plus interest, and subsequently reinvests immediately in new state bonds; or, if she does not want to reinvest new creditors in her place are needed to grant the state credit. This procedure is called “follow-up financing”.

This is not a debt trap in which states accidentally step into. This relation to the financial markets is actively sought simply because their purpose is not to be debt free, but commercially successful.

The whole process depends on the on-going repurchase of debt. Therefore, a closer look at what makes sovereign debt so attractive for the main creditors (the financial industry and other states) is in order. And to answer the question about debt crisis specifically, we must inquire as to the conditions in which sovereign debt becomes unattractive to these creditors.

Before that, one more point. So far this text has only discussed debt which was taken on in the past and how this debt is repaid. However, in almost perfect regularity the mountain of debt is growing each year, which means that new debt is added to the existing. Those debts which are contracted in addition to the follow-up financing debts are called “new net debt”. And to clear up

a few common confusions that stem from fiscal jargon: if politicians talk about a balanced budget, then this only means that this year no new net debt shall be added to the existing gross debt. The state still has to take on new loans to pay off the old that are now due to be paid. When politicians say that they want to save or adopt an “austerity budget” then this sometimes only means that they want to spend less money than planned last year. This may include that they spend more money than last year and that they take on more debt than last year. Sometimes “austerity” simply means to contract less new debt than last year. The total gross debt still increases. These remarks are intended to counter the confusion that arises from the usage of terms such as “saving” in government finance. For individuals “saving” indeed implies spending less money not so for states. Calling taking on less new debt than last year “saving” highlights with peculiar force how self-evident the course of debt is for politicians.

1This text is a translation and in some places adaptation of our text “Staatsverschuldung und die Krise im Euroraum” published in November 2011 at <http://junge-linke.org/staatsverschuldung-und-die-krise-im-euroraum-alle-teile>.

2Common synonyms for sovereign debt are government debt, national debt or public debt. Yet, it is not the government, the nation, or the public which is the debtor but the state. Hence, we opted for “sovereign debt” and avoided these synonyms.

3What newspapers actually mean is that Greece has the highest debt level compared to its national economic output measured in a state’s GDP, i.e., it has the highest relative debt. Nevertheless, it is often written that Greece’s sovereign debt is the largest, and people who are less knowledgeable in respect of state finances may well often hold the view that Greece indeed is indebted the most in absolute terms.

4By “democratic state” we simply mean successful capitalist, “Western” states such as those in the Eurozone, the UK or the USA. When we write about the democratic state we simply mean features that these states have in common, i.e., those features which are an integral part of them being democratic states.

5Of course, private persons too can apply for credit up to some limit. This limit is especially low if a loan is solely for such unproductive expenditures as food and rent.

6<http://ipayroadtax.com/no-such-thing-as-road-tax/bring-back-the-road-fund/> accessed 31.12.2011

7The difference how its policies affect the two classes constitutes the reason why budgetary policies repeatedly and resolutely turn to social welfare whenever austerity is on the menu. Politicians call this saving and the truism that one cannot spend more than what is there to make this all plausible. This platitude holds true for every wage labourer but certainly not for the state. Since the state generates its income by enacting resolutions, its only limit is the amount of money actually available in society. Up to this limit the state may spend as much as it wants. If the state abstains from collecting income it must have its economic reasons. The reason for the cutbacks in social benefits is thus simple: the state deems money in the hands of businesses much more useful than in those of hardship cases. The latter do nothing else but spend it on consumption while the former accumulate it.

8A last fundamental reason for loans is war. For the production and security of their own political position in the world states are willing to take on large amounts of credit just have a look at the

war against terror of the United States. However, why states wage and prepare for wars is not the subject of this text.