Balanced Budget and Deficit Spending in Europe
Experiences from the Baltic Sea Region

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Abstract

One of the main economic problems of our time is that of reducing budget deficits. In Europe the "Stability and Growth Pact" should reduce deficit spending and government debts. But EU core countries such as France, Germany and Italy have been in violation of the Pact consistently for a lot of years. In contrast the new EU-member Estonia has been successful in keeping the budget deficit low. Also Denmark - a long term member of the European Union - has recorded a surplus in its national budget since 1997.

In this paper the different institutional conceptions of a balanced budget in Estonia and Denmark are analyzed and compared. As can be shown easily balanced budget rules are able to reduce budget deficits respective to hinder the development of larger deficits. But it must be also emphasized that political consensus about the reduction of deficits respective of a consequently balanced budget is the most successful strategy. But even where no consensus exists constitutional rules and additional application rules are necessary. As result of the analysis an EU balanced budget framework will be recommended to reduce deficit spending in the European Union.

JEL classification: H6, P16

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Just as an alcoholic might embrace Alcoholics Anonymous,
so might a nation drunk on deficits and gorged with government
embrace a balanced budget and monetary stability.
James Buchanan (1977/2000, p. 166)

1. Deficit Spending in Europe

One of the main economic problems of our time is that of reducing budget deficits. When the government spends more than it takes in through taxes or other methods of acquiring funds, it must make up the difference by borrowing. But a debt requires large portions of governmental revenues going not to any program or need but merely to pay interest to investors. And most of that spending goes toward relatively unproductive economic pursuits such as welfare transfers. Additionally a government's ability to incur essentially limitless debt leads invariably to the expansion of government into areas which should be free of state activity.

Therefore recent years have witnessed an increased interest in institutional constraints on fiscal policy makers. In particular “balanced budget” requirements must be mentioned. For example in the United States weak forms of balanced budget rules are implemented in most states. A similar rule has repeatedly been suggested for the federal government, too. (Niepelt 2007, p. 145) Since the early 1980s, several European countries have adopted fiscal consolidation programmes aimed at stabilizing their public dept-to-GDP ratios. (Drudi/Prati 2000, p. 1897) In the European Union the “Stability and Growth Pact” should reduce deficit spending and government debts. According to this agreement EU member states should keep their budgets stable or in surplus in the long term. A 3% limit on public sector budget deficits and a 60% limit on debts in relation to GDP have been set out as rules. Furthermore, fines are imposed for those who exceed the budget deficit limits. It has been commended that this 3% limit leaves enough room for automatic fiscal stabilizers to work without the necessity to use discretionary fiscal measures when the structural budget is in balance. (Kattai et al., p. 4) Nevertheless, the Pacts success is questionable. EU core countries such as France, Germany and Italy have been in violation of the Pact consistently for a lot of years. For instance Germany has been given a 2007 deadline to get its budget deficit below 3 per cent. Fortunately in 2006 Germany's public deficit fell to about 2.2 percent of its gross domestic product, well below the Euro zone limit of three percent. (See table in the annex.) But did the

“Stability and Growth Pact” redirect the course of spending to make it more effective in generating economic activity? It must be assumed that this would require a drastic philosophical change of attitude that much of Europe is unwilling to accept. Beside Ireland and Bulgaria especially the development of budget deficits in Denmark and Estonia seems to be very interesting. While Denmark has been able to reduce its budget deficit from 77.4% of GDP in 1994 to 35.9% in 2005 Estonia’s gross dept amounts in the same period constantly for 4.5% - 6.5% of GDP. (See table in the annex.)

In this paper the different institutional conceptions of a balanced budget in Estonia and Denmark will be analyzed as a contrary way of budgeting compared with the deficit spending in EU core countries. As can be shown easily balanced budget rules are able to reduce budget deficits respective to hinder the development of larger deficits. But it must be also emphasized that political consensus about the reduction of deficits respective of a consequently balanced budget is the most successful strategy. But even where no consensus exists constitutional rules and additional application rules are necessary. As result of the analysis an EU balanced budget framework will be recommended to reduce deficit spending in the European Union.

2. The Theory of Balanced Budget Rules

Prior to World War II for politicians it has been considered to be immoral to spend more money than they were willing to generate by taxes, except during periods of extreme emergency. To spend borrowed funds on items for public consumption has been no acceptable behaviour. (Buchanan 1997, p. 119) In contrast, since the political conversion to Keynesianism, we have been told that deficits today will stimulate the economy into producing full-employment surpluses tomorrow. Only tomorrow never seems to come! Deficits have become more and more “a way of life”. (Buchanan 1977/2000, p. 165) But also the neoclassical theory of fiscal policy (e.g. Musgrave 1959, or Barro 1979) stresses the importance of constant tax rates to minimize distortions while budget deficits should be used to cover temporary increases in government spending. (Milesi-Ferretti 1997, p. 4) By this way Keynesianism as well as Neoclassic Economics pioneered deficit spending in the Western Industrialized Nations until present days.

How to escape from the trap of deficits? As can be shown easily in a simple Public Choice model ordinary politics cannot balance the budget. To reduce budget deficits, costs must be imposed on current-period taxpayers as well as on current-period beneficiaries of public spending programs. Either taxes must be increased or rates of public spending must be reduced. But there will be predictable electoral feedbacks on those politicians that introduce such burdens on the voters. It is clear that there are no incentives for politicians to take the political costs for a long-term reduction of deficit burdens, while – at the same time – they must fear that all of their current efforts are vulnerable to dissipation by other political coalitions in the future. (Buchanan 1997, p. 122)

If no consensus about a balanced budget exists, only a balanced budget amendment to the constitution or other balanced budget rules can restrict politicians in spending borrowed funds. A "balanced budget" equals the projected income to the government through taxes, fees, and other revenues to the amount proposed to be spent. Of course, any strict balanced-budget restriction must be considered as being imposed only on an overly simplified model. (Buchanan 1967/2001, p. 97) Even at base, there exists no possibility of having an unbalanced budget. There is only a choice among different means of achieving transfers of resources from citizens to the government. But while current citizens bear the burden of taxation as well as money creation, future taxpayers bear the financial burden of deficit spending. A balanced budget requirement only implies that the government must be forthright about the uses of its shifted resources. By this way a balanced budget requirement is simply a requirement of truth in labelling. As the experience has shown, people will generally make better decisions when they bear the responsibility for the consequences of their choices. (Tollison/Wagner 1986, p. 376) This has been already pointed out in the "Haftungsprinzip" (principle of responsibility), one of the basic principles of a market economy in the sense of the "Freiburg School of Economics" in the middle of the last century. (Eucken 1952/90, p. 254-291) While money creation or borrowing weakens the responsibility that politicians must take for their spending choices, a balanced budget requirement is a means of promoting responsibility in budgetary choice. (Tollison/Wagner 1986, p. 376)

However, it must be emphasized that the introduction of a balanced budget requirement is a choice among rules in contrast to choice within rules. And it is clearly more difficult to get an agreement on a change in the rules of any game while the game is being played than it is to get an agreement on a set of rules before playing the game begins. (Buchanan 1997, p. 123-124) Therefore it is an additional question how to implement a balanced budget requirement. Additionally, as one can imagine a simple balanced budget amendment to the constitution will have a symbolic significance but the application rules will be responsible for the real results. By this way a balanced budget can only achieved by a sophisticated approach, including an amendment to the constitution as well as concrete application rules.

3. Experiences with Balanced Budget Rules from the Baltic Sea Region

3.1 The Case of Estonia

Estonia has been continuously successful in keeping the budget deficit low, because a balanced budget over the medium-term has been one of the foundations of the economic policy of the newly independent state. (Walter et al. 2006, p. 33) Since 1993 in Estonia the principle of balanced budget is set out by the State Budget Act and several other pieces of legislation according to external audit, the formulation of local government budgets, etc. Because the formulation of the balanced budged requirement in the State Budget Act has been quite fuzzy, a political consensus about fiscal policy in Estonia has been also important. (Martinez-Vazquez 1997, p. 2-12)

The Estonian approach of balanced budget is quite flexible. Because of external shocks it does not make much sense for a small open economy like Estonia to require a balanced budget every year. Therefore there exists some leeway for the government to balance revenue and spending over several years. This rule became necessary, since the government was unable to ensure a balanced budget in the early years of transformation. (Freitag 2003) As Kattai/Lewis (2005, p. 53) pointed out the current Estonian budget setting system is really flexible because it permits automatic fiscal stabilizers and some discretionary response to operate. On the other hand the application rules work well. All draft amendments to the budget and budget drafts are required to provide alternative sources of financing by article 116 of the constitution. Additionally, Estonia has a proper external audit institution. The State Audit Office is operating since 1992 as an independent organization. It has the mandate to carry ex-post audit of all state budget organizations. Additional the Estonian municipalities are limited to borrowing levels that commit them to dept service of no more 20% of their total revenues. (Martinez-Vazquez 1997, p. 4-19) By these institutional arrangements fiscal discipline could be maintained.

Of course, Estonia has been a transformation country. Therefore also the budgetary process has not been without distortions. After the State Budget Act was put into practice, there were some irritations because the general government balance has not been defined clearly. Also the distinction between revenue and lending was unclear. The official understanding of public revenue seems to have been a kind of cash flow but not the normal understanding of government revenue, consisting of taxes, customs, fees etc. (Freytag 2003) Additionally, there has been a lack of explicit statement of government priorities for budget policy. In the 1990s Estonia’s budget process failed a strict test of comprehensiveness and universality. The budgetary control of the social funds lacked, too. (Martinez-Vazquez 1997, p. 5) When the Estonian government has adjusted its budgetary rules according to EU law in 2002, these problems have been solved mostly. (Freytag 2003)

Summarizing, it can be mentioned that Estonia’s legal budgetary framework has no significant gaps. By the balanced budget system the country has performed its budgetary rules better than most other transformation countries. (Martinez-Vazquez 1997, p. 3) As result of the restricting budgetary policy the Estonian gross dept amounts since 1997 constantly for 4.5% - 6.5% of GDP. (See table in the annex.) The country has never had a bigger annual deficit than 3.7% in one exceptional year. (Schneider/Zapal 2006, p. 141) Therefore only a small share of the Estonian budget is spent for interest payments. As result there exists room in the budget for public investment as well as for social spending.

3.2 The Case of Denmark

While Estonia is a transformation country and a new member of the EU Denmark is a long term member of the European Union. But Denmark didn’t introduce the Euro and continues to act autonomously with regard to financial policy. Denmark has recorded a surplus in its national budget since 1997, which implies that the country in fact fulfilled both the convergence criterion for a balanced budget and the Stability and Growth Pact's medium-term goal of being 'close to balance or in surplus'. With reference to future demographic problems and financial pressures, the Danish government had aimed for decisive budget surpluses in order to reduce government debt of over 60% in 1997 to about 36% by 2005. (Volz 2004)

As reasons for such a successful budgetary policy the strong boom of the 1990s accompanied with a very high level of indirect taxes must be mentioned. But first of all a lot of institutional key characteristics of the Danish budgeting system have to be emphasized: First of all Denmark's policy is characterized by consensus through negotiations, because Denmark has a history of coalition minority governments. The fact that different political parties provide the majority for different proposals means that each government is engaged in consensus building with most other political parties. (Blöndal/Ruffner 2004, p. 53) This can be seen as an unique factor in Denmark or as an unique "internal institution" supporting the establishment of consensual fiscal rules.

By this way, in 2001 the Danish government implemented a widely supported medium-term economic and fiscal program: "En holdbar fremtid – Danmark 2010" (A sustainable future – Denmark 2010). This program can be seen as the "anchor" for budgetary policy in Denmark over the last years. The overall objective is to ensure that fiscal policy is sustainable in the long term, while sustainability is defined so that the level of taxation as well as standards of public service per user reached in 2010 can be maintained in the future despite of large demographic changes. In essence, this means running budget surpluses until 2010 in order to reduce the amount of dept. (Blöndal/Ruffner 2004, p. 53) The Danish Ministry of Finance concretizes: "The operational target consistent with fiscal sustainability is to maintain a budget surplus of 1½-2½ percent of GDP on average until 2010. (…) Moreover, the government aims to halve the general government debt as a share of GDP by 2010." (Finansministeriet 2003, p. 3) It must be pointed out that the Denmark 2010 programme does not provide an explicit hard budget constraint in any given year, similar to the Estonian regulation. (Blöndal/Ruffner 2004, p. 54) Additionally it must be mentioned that the budgetary restrictions are not set out in the Danish constitution. Nevertheless, the Denmark 2010 program works like a balanced budget amendment, basing on political consensus instead of constitutional rules.

Also the Danish budgeting system is characterized by negotiations between the Ministry of Finance on the one hand and the spending ministries as well as the municipalities on the other hand. Each June, the negotiations of the Ministry of

Finance and the spending ministries take place basing on the ministry's submissions and the conclusions of special studies. Denmark operates a system of expenditure ceilings for the spending ministries. Each of these ministries then has the responsibility for final reallocation of funds within its portfolio. (Blöndal/Ruffner 2004, p. 57-58) Because of its central position in the budgeting process the Ministry of Finance has been regarded even as "second to God" or a "modern Richelieu" in Denmark. (Jensen 2003, p. 166)

Last but not least, Denmark is characterized by a very high degree of decentralizing. For historical reasons especially the municipalities hold a political strong position in Denmark (Jensen 2003, p. 168) Almost two-thirds of total general government expenditure is carried out by the regional and local governments. The share of own revenues of regional and local governments in financing this expenditure is around 80%, while the remaining 20% are paid by block grants from the central government. In negotiations between the organizations of local governments and the Ministry of Finance the size of block grants is fixed by agreement. (Blöndal/Ruffner 2004, p. 54-56) As a general rule, regional and municipal governments must operate a balanced budget, i.e. they have to finance their expenditures – operating costs, investments and debt service - by way of current revenues but not by loans. Of course, there are important exceptions to this main rule. (Pedersen 2006, p. 100 - 102) Additionally, it must be mentioned that there exists a great pressure for increased spending by municipal and regional governments in Denmark. (Blöndal/Ruffner 2004, p. 56)

Summarizing, it must be emphasized that budgeting in Denmark is characterized by a strong political consensus through negotiations. The Denmark 2010 program as well as the annual budgets of the spending ministries or municipalities is negotiated in consensus. While an explicit balanced budget rule exists for municipalities, the Denmark 2010 program has no constitutional status. In Denmark almost budgetary institutions are not fixed by the constitution but by ordinary laws or operational regulations. They work well because of the consensus in society as well as in the political class. That shows the importance of internal institutions also in the budgetary process.

4. Conclusion

As Buchanan (1997, p. 129) has emphasized, in a setting of rules in which the central bank keeps the value of money stable and in which the government budget is balanced, the major internal sources for instability are eliminated. So each balanced budget rule can be seen as an important stabilizing element. By this way also the European "Stability and Growth Pact" works as stabilizing element within the European Union. But the Pact-rules are not stringent leaving a lot of possibilities to avoid the rules. Therefore it is necessary not to discuss a higher degree of "flexibility" of budgetary rules in Europe but to introduce clearer "balanced-budget-rules". Because it must be assumed that the exists no consensus about a deficit avoiding fiscal strategy in all European countries, concrete balanced budget requirements have to be set out in the European treaties or – in the future – in the European Constitution. Here the symbolic significance of a clear constitutional rule for budget balance in all EU member countries should not be overlooked. But additionally well working application rules must be implemented, too.

As the experience of the "Stability and Growth Pact" has shown the current budgeting rules in Europe improved the dept situation in some countries but failed relative to setting clear rules of a balanced budget in others. (See table in annex.) Also the reform of the Stability and Growth Pact in 2005 did not change the situation really. The reformed Pact now includes a number of provisions that explicitly tackle sustainability and the need of member states of embarking in bold structural measures that contribute to reduce their implicit liabilities, e.g. from the pension system. By this way the reform shifted the obligation from short-term consolidation towards structural reforms. (Buti/Martins 2006, p. 302) But it did not help solving the problem of deficit spending because the basic incentives for politicians did not change. A "close to balance" imperative is no really balanced budget requirement.

As result it must be pointed out that budgetary rules only which require a medium-term zero-limit on public sector budget deficits as well as a long-term goal of a zero-percent-limit on debts in relation to GDP will help Europe to reduce deficits and dept-rates consequently. In contrast to small countries like Estonia or Denmark, Europe is such a heterogenous society that no political consensus about stringent fiscal behaviour will be possible. As has been emphasized the introduction of a balanced budget requirement is a choice among rules in contrast to choice within rules. And it is clearly more difficult to get an agreement on a change in the rules of any game while the game is being played than it is to get an agreement on a set of rules before playing the game begins. Therefore new negotiations about a balanced budget requirement in the European Constitution would be the right way.

Appendix: General Government Gross Debts in Europe, in % of GDP, 1994-2005

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
EU 25	:	:	:	:	67.5	66.7	62.9	62.0	60.4	62.0	62.4	63.2
EU 15	66.4	70.8	72.6	71.0	68.9	67.9	64.1	63.1	61.5	63.0	63.3	64.5
Belgium	135.9	134.0	130.2	124.8	119.6	114.8	109.1	108.0	103.3	98.6	94.3	93.2
Bulgaria	:	:	:	105.1	79.6	79.3	73.6	66.2	54.0	46.1	38.6	29.9
Czech Rep.	:	:	:	12.2	12.9	13.4	18.2	26.3	28.5	30.1	30.7	30.4
Denmark	77.4	73.2	69.7	65.7	61.2	57.7	52.3	48.0	46.8	44.4	42.6	35.9
Germany	49.3	57.0	59.8	61.0	60.9	61.2	60.2	59.6	60.3	63.9	65.7	67.9
Estonia	:	:	:	6.4	5.6	6.0	4.7	4.7	5.6	5.7	5.2	4.5
Ireland	89.6	81.8	73.3	64.5	53.8	48.6	38.3	35.9	32.2	31.1	29.7	27.4
Greece	107.9	108.7	111.3	108.2	105.8	105.2	114.0	114.4	110.7	107.8	108.5	107.5
Spain	61.1	63.9	68.1	66.6	64.6	63.1	61.1	56.3	52.5	48.7	46.2	43.1
France	48.4	54.6	57.1	59.3	59.5	58.5	56.8	56.8	58.2	62.4	64.4	66.6
Italy	124.8	124.3	123.1	120.5	116.7	115.5	111.2	110.9	105.6	104.3	103.9	106.6
Cyprus	:	:	:	:	61.6	62.0	61.6	61.9	64.7	69.1	70.3	69.2
Latvia	:	:	:	:	9.8	12.6	12.9	15.0	13.5	14.4	14.5	12.1
Lithuania	:	:	:	15.2	16.5	23.0	23.8	22.9	22.2	21.2	19.4	18.7
Luxembourg	6.3	6.7	7.2	6.8	6.3	5.9	5.5	6.7	6.5	6.3	6.6	6.0
Hungary	:	:	:	64.2	61.9	61.2	55.4	52.2	54.0	55.8	56.3	57.7
Malta	:	:	:	51.5	64.9	56.8	56.4	63.5	60.1	70.2	74.9	74.2
Netherlands	76.4	77.2	75.2	69.9	66.8	63.1	55.9	51.5	50.5	52.0	52.6	52.7
Austria	63.4	67.9	67.6	63.8	64.2	66.5	67.0	67.0	65.8	64.6	63.8	63.4
Poland	:	:	:	44.0	39.1	40.3	36.8	36.7	39.8	43.9	41.9	42.0
Portugal	62.1	64.3	62.9	59.1	55.0	54.3	53.3	53.6	55.5	57.0	58.6	64.0
Romania	:	:	:	16.5	17.8	24.2	22.7	:	23.8	20.7	18.0	15.2
Slovenia	:	:	:	:	23.6	24.9	27.4	28.4	29.1	28.5	28.7	28.0
Slovakia	:	:	30.6	33.1	34.0	47.2	49.9	49.2	43.3	42.7	41.6	34.5
Finland	58.0	57.1	57.1	54.1	48.6	47.0	44.6	43.6	41.3	44.3	44.3	41.3
Sweden	73.9	73.7	73.5	70.6	68.1	62.7	52.8	54.3	52.0	51.8	50.5	50.4
UK	48.6	51.8	52.3	50.8	47.7	45.1	42.0	38.7	37.5	38.9	40.4	42.4
Croatia	:	:	:	:	:	:	:	:	40.0	40.9	43.7	44.2
Turkey	:	:	:	:	:	:	:	104.4	93.0	85.1	76.9	69.6

Source: Eurostat (2007).

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