A Greek Tragedy

With Greece in economic collapse brought about by a bloated public sector and chronic over-promising by the state, it is becoming increasingly clear that the European-style welfare state is in serious trouble. At events in April and May, experts discussed how Greece got to be in such bad fiscal shape, how that nation can reform, and what Greece's experience means for the rest of the European Union. Speaking were Simeon Djankov, minister of Finance and deputy prime minister of Bulgaria; Cato senior fellow Steve Hanke; and Takis Michas, staff writer for the Greek national daily, *Eleftherotypia.*

SIMEON DJANKOV: The view of European finance ministers, and politicians generally, is that the Euro is here to stay—and that Europe should take all necessary steps to ensure it remains a strong currency. Some of the actions in the last few days have shown that there is some resolve here, and they have met with some success, but we may well find out in the following days and weeks that more needs to be done.

Most countries—Greece most prominently—have lived well beyond their means for at least the last decade. They have gotten into so much debt that countries like Greece, especially after joining the Euro, have been lulled into complacency and have been spending enormous amounts of money—more than their economies can generate, or will generate for years to come. Were this a problem for Greece only, we might write it off. Soon, however, we will likely be talking about other countries as well, both in the Eurozone and beyond. If you take a careful look at the fiscal situation across countries, you will find there are others, such as the United Kingdom, that have higher debt levels, and certainly higher deficits, than Greece.

The cause of the problem is that, especially over the last decade or two, Europe has become decreasingly competitive relative to Asia and, somewhat strikingly, given what's happening there, the United States.

What is it about Europe that makes it less competitive? Significantly, it has a poor environment for doing business, caused by overregulation. From the beginning of the World Bank's "Doing Business" report, Greece was shown as a middle-income country that very heavily regulates, and has well-organized labor unions that prevent sensible reforms of pensions, public administration, health care, and education.

There are other countries that fit this model: Spain, Portugal, and, to some extent, Italy. This is evidence that the level of regulation—and the related level of taxation—is too burdensome to these countries' economies. In other words, if you are already a fairly rich country, like Sweden, maybe you can allow yourself a high level of taxation and regulation, but if you are still a middle-income country trying to grow while sustaining a fairly high standard of living, then you should be more business-friendly.

Europe has a lot more regulation than is needed, a lot heavier public administration than is needed, and very little reform in some of the key social sectors. The European excuse is that, because we are social democracies, we are already well-off and democratic, so we don't need reforms better suited to developing countries. Nor, Europeans continue, do we need some of the "right-wing" tax policies of the U.S., because we live in a more sophisticated, advanced society. We can just continue, somehow, as we are.

Since at least 2000, there had been a realization in Europe that competitiveness needed to improve. In typical bureaucratic fashion it was decided that, beginning in 2000, we would have the "Lisbon Agenda." The Lisbon Agenda insisted that in 10 years—by 2010—Europe would be more competitive than the U.S., and there were a number of indicia that were supposed to signal when that goal had been reached. At the end of this year we will get the Lisbon Agenda's report. I am sure it will be very well written, and will say that, while we have not quite succeeded, there have been some notable advances. If you look at the indicators, though, it is quite striking. In the last 10 years Europe has not only failed to catch up to the U.S., it has gotten relatively less competitive. In other words, the U.S., despite all its hang-ups in the last 10 years, somehow has managed to separate itself even further from Europe. (Asia has done even better, including countries such as China and Vietnam that are not considered bedrocks of capitalism.)

In short, for 10 years Europe has done nothing to increase its competitiveness and, in fact, its relative competitiveness has fallen. This has not prevented the European Commission from deciding to create another 10-year plan called "Europe 2020." The idea, once again, is that over the next decade Europe will catch and surpass the United States. I am sure this is not going to happen, given that the discussion about what indicators to use primarily concerns how to fudge them.

If there is something good about this current crisis, it is that it's starting to make clear, in a serious manner, that we cannot keep going as we've been. But if there is a change it will not come from Western Europe. That's been tried already. Rather, it will come from what's called the "New Europe," the Eastern European countries. While these

countries are individually small, in coalition and with the help of some of the more reform-minded countries in Western Europe they can create enough pressure to introduce meaningful changes to the European Union. If you put Europe's reformist policies on a continuum from left to right, from no change to radical change, you will see that the most radical reforms over the last 10 years, from both socialist and not-so-socialist governments, have all come from Eastern Europe. These countries have led the charge on becoming more business friendly and competitive.

In a way one can say they had to in order to become globally competitive. But some of these countries have continued to do so even after achieving a reasonable level of well-being, and surpassing some of the older European Union members. One such country, which I think is the standard bearer, is Estonia. Estonia has done all the necessary things to go from being a Soviet basket-case to one of the best economies in Europe, notwithstanding the crisis and other issues. Hopefully, within a few weeks, Estonia will succeed in joining the Euro zone. Estonia serves as an example of a country that had a lot of things to do and did them, regardless of whether the political party in charge was to the left or to the right.

I am almost alone, among my fellow finance members, in thinking that improving European competitiveness is a meaningful goal. The other ministers seem to think this is somehow too petty, too small, or too non-European. I hope this crisis reminds us that it is very European to be competitive, and once we are competitive, then we can do other "sophisticated" European things.

STEVE HANKE: How did Greece get into this death spiral that they're in? Unfunded entitlements. In other words, promise somebody something, don't come up with the financing for it, and pretty soon you have yourself in a fiscal/debt crisis. This is where Greece ended up, and in February they called in some outside advisers (Professor Stiglitz for one), and the blame game began. The prime minister, who is also the head of the Socialist International, started blaming everyone. The speculators were the first. Then he went on a tear against his own colleagues in the European Union. The Germans really got whacked—they were a big cause of the trouble.

Ironically, after blaming outsiders for all their problems, the Greeks have called in the foreign doctors. In this case it isn't just the IMF, but also the EU politicians and bureaucrats who are involved. I think this will ultimately be a case in which the doctors kill the patient. They've started the sequence not with what they should be doing, but with an austerity program. There have been promises that government expenditures in Greece will be cut. There have also actually been some tax increases. Unlike Bulgaria, which did exactly the right thing by refusing to increase its VAT, Greece has increased the VAT twice since the crisis.

Steve Hanke

> "How did Greece get into this death spiral that they're in? Unfunded entitlements."

But there are no structural reforms, outside of what I call "fiscal structural reforms," in the proposals for Greece's recovery. What should they have done? They should have started with a Big Bang, doing a number of things simultaneously à la New Zealand. In 1984, New Zealand elected a Labor government after the conservatives had made a complete mess of the economy. The Muldoon government introduced, over a course of years, a socialist system in New Zealand. Labor, under finance minister Roger Douglas, introduced structural reforms centered on competitiveness. As a consequence, New Zealand had a massive economic revolution after the '84 election, and that should be part of Greece's Big Bang.

Greece should have begun by rescheduling their debt. They also should have implemented a supply-side fiscal consolidation. What that means is that you cut government expenditures, but also change the taxing setup. Right now, Greece has very onerous payroll taxes that are paid by employers and, ultimately, labor. As part of the Big Bang, what Greece should do is eliminate employers' contribution to payroll taxes. The other thing they should do with respect to supply-side fiscal consolidation is to make the VAT uniform. Right now, there are three VATs in Greece. This is a typical in Europe. You have the regular VAT, a VAT that is reduced by 50 percent for other categories, and, finally, a super reduced VAT. I would eliminate the reduced and super-reduced rates, and just have one, uniform rate for the VAT.

If you did those two things you would end up generating more revenue than they are generating right now. Even on a static, simple-minded analysis, you would be ahead of the game by making that change. But, more importantly, you would reduce the labor cost in the economy. The contribution of employers right now is 7.8 percent of GDP. By eliminating the employer contribution you would get a 22 percent reduction in the overall burden on wages as a percent of GDP in Greece. You would make the economy more competitive. You would also, obviously, reduce consumption, increase savings, and reduce the level of debt in the country.

Let me make a comment about devaluation. There are some people—Professor Krugman, for example—who are wringing their hands saying, "Well, the problem with Greece is that they've gotten themselves into this straightjacket of the Euro and they

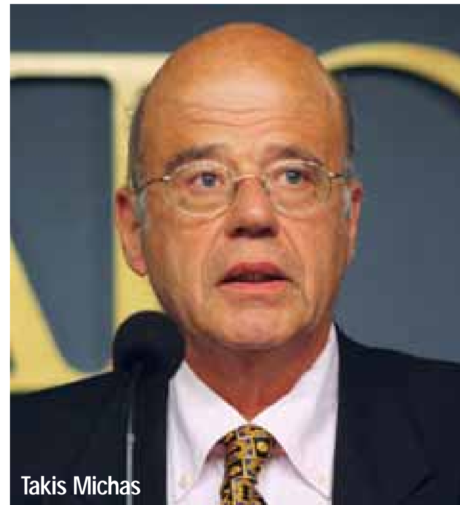
can't devalue the Drachma, anymore. So they're in the soup. There's nothing they can do!" But, as I've just pointed out, there is something they can do. They can make a 22 percent reduction in the total labor cost to the economy, simply by eliminating the employer contribution to payroll taxes. If we assume that 50 percent of the devaluation would be passed through to the economy—a reasonable assumption about a small, open economy like Greece's—you would have to have a 44 percent devaluation to be equivalent, in terms of competitiveness, with the elimination of the employer contribution to payroll taxes. So you get a lot by eliminating the payroll tax. You get the equivalent of a 44 percent devaluation of their currency (if they still have a currency), without the inflation, and widespread private sector bankruptcy, that would go along with that.

The ideal end game for Greece would be a New Zealand kind of Big Bang. They'd get their reputation back, get their confidence back, and have a pro-growth strategy that attacks Greece's fundamental structural problems.

TAKIS MICHAS: Greece has been called by various analysts "the last existing socialist state in Europe," or "the last Marxist state." All of these terms denote the predominance of politics in the economy. Yet one could say that Greece better fits the model of a post-socialist society, as described by Yegor Gaidar. It is a form of capitalism where the bureaucracy and its allies consider the state their property, and use its mechanisms for personal enrichment.

In Greece, the fundamental principle that has been dictating economic and political development since the creation of the Greek state in the 19th century is political clientelism. This is a system in which political support is provided in exchange for benefits. In this situation, rent-seeking—the attempt by various groups and individuals to influence the location of political benefits—becomes paramount. The origins of political clientelism can be traced back to the origins of the Greek state in the 1830s. As a left-wing political historian puts it, "The fundamental structure of Greece has never been civil society. Ever since the middle of the 19th century, nothing could be done in Greece without its necessarily passing through the machinery of the state."

The social group that took over the running of the Greek state after liberation from the Ottomans was primarily the village notables. Their power, under Ottoman rule,


Takis Michas

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lay not in their ownership of Greek land, but in the fact that they acted as tax collectors for the Ottomans, something that gave them prestige, power, and wealth. Their new role, as leaders of the Greek state, was continuous with the old one. Tax collection was still their major business. However, under the new conditions, they did not have to transfer the proceeds to the Ottoman rulers, but could keep them for themselves. At the same time, they could utilize the networks of local allegiances they had built under Ottoman rule and carry them into the new state. Political offices gave them seemingly inexhaustible resources.

In Western Europe, and, especially, in Northern Europe and the Anglo-Saxon world, the State was seen primarily as the protector of certain Lockean rights, especially the right to own property. This conception, as has been frequently noted, went hand in hand with a ruling class that had a vested interest in large property-holdings. In the new Greek state, on the contrary, owing to the absence of a large landowning class, the ruling class saw the state not only as an instrument for pre-existing assets, but as its source of income par excellence. Hence, the conquest of the state apparatus did not only serve the power and ambitions of various individuals, it also became the most important mechanism for the distribution of material rewards and benefits.

The benefits that the political system could bestow upon the clients took many forms. The most important of these was the provision of jobs in the civil service to supporters and their kin. This quickly led to an explosion in the number of people employed by the state. By the late 1880s, when Greece was still an agricultural country which had barely begun to industrialize, Greece had one of the largest civil services in Europe. Per 10,000 inhabitants there were 200 civil servants in Belgium, 176 in France, 126 in Germany, and 73 in Great Britain. In Greece the number was 214. This went hand in hand with a rise in public expenditure. By the latter half of the 19th century, Greece had one of the highest ratios of public expenditure to GDP. It was 19.1 percent, compared to 6.6 percent for England, 13.2 percent for France, 10 percent for Germany, and 7 percent for the U.S. The largest part of public expenditure was directed, not to public works or infrastructure, but to the wages of public service workers and civil servants. The grounds for the rent-seeking struggles of the future were thus firmly laid. Everybody wanted to join the civil service.

Much water has, of course, gone under

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for hope but also warning of threats to the continued growth of liberal democracy on the world's poorest continent.

Pulling Back the Curtain on the Federal Reserve

The Federal Reserve was at the center of the financial crisis and continues to play a significant role in the government's response. Yet the institution's inner workings remain hidden from the public. In **"The Case for Auditing the Fed Is Obvious"** (Briefing Papers no. 118), Cato Institute adjunct scholar Arnold Kling looks at the debate surrounding calls to audit the Fed and offers a plan for what an audit should look for. "What is presented as concern about threats to the political independence of the Fed," he writes, "is in fact a concern about a threat to the myth of the Fed's technocratic competence." This concern has led to a showdown between progressives—who want to maintain the Fed's air of infallibility—and libertarians and conservatives. Kling says maintaining this myth must not stand in the way of an audit. If the audit occurs, he writes, it should focus on two aspects of the Fed's behavior: the process by which it makes its decisions and the profits and losses of its investments. Having this information would better enable us to address future crises effectively. "How can anyone be so certain of their views on these matters," Kling asks, "that they would not like to see the facts brought to light?"

Don't Miss the Cato Institute's Policy Bulletins

Every month, the Cato Institute publishes short policy studies called bulletins. In May, Václav Klaus, president of the Czech Republic, wrote an Economic Development Bulletin, **"When Will the Eurozone Collapse?"** He argues that "the European monetary union is not at risk of being abolished. The price of maintaining it will, however, continue to grow."

Jorge Castañeda, foreign minister of Mexico during the administration of President Vicente Fox, wrote **"Mexico's Failed Drug War,"** another Economic Development Bulletin. He looks at the War on Drugs from Mexico's perspective, writing, "We are in this mess today, as opposed to over the last 40 or 50 years, because when the current president, Felipe Calderón, took office over three years ago, he felt that he had no choice but to declare a full-fledged, no-holds-barred war on drugs."

Duanjie Chen and Jack Mintz, of the University of Calgary, wrote **"U.S. Effective Corporate Tax Rate on New Investments: Highest in the OECD,"** a Tax and Budget Bulletin. Their paper "presents estimates of effective corporate tax rates on new capital investments in 80 nations for 2009" and finds "that the U.S. effective corporate rate is 35.0 percent, which is much higher than the 80-nation average of just 18.2 percent."

Cato recently launched two new bulletins. The Nuclear Proliferation Update is dedicated to promoting peaceful resolutions to the nuclear crises in North Korea and Iran. It aims to provide policymakers with analysis on the latest developments in both nations and options for formulating coherent U.S. responses. In highlighting the importance of achieving diplomatic solutions, the goal is to avoid armed conflict and its attendant consequences.

The Immigration Reform Bulletin provides timely information, insight, and analysis about efforts to expand opportunities for legal immigration to the United States. The bulletin focuses on immigration policies that promote economic growth, national security, and individual liberty.

These bulletins, along with all of Cato's publications and e-mail lists to stay abreast of new releases, can be found at www.cato.org.

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the bridge since those days. Greece experienced wars, revolutions, occupations, bankruptcies, dictatorship, and earthquakes. If there was one thing that remained constant throughout this period, it was the system of political clientelism as the central organizing principle of Greek society. Of course, some things have changed. From the middle of the 1930s onwards, political parties have become more centralized than the loose coteries of personalities heading extended patronage networks they used to be. The clientelistic orientation remained intact.

Another thing that changed, of course, was the rhetoric that justified the distribution of benefits. Client groups today receive benefits in the name of social justice, national necessity, or acquired rights. Those three concepts are extremely prominent in the political discourse of Greece and, I expect, elsewhere.

Clientelism in Greece has gone hand in hand with the development of an oversized state apparatus where social groups competed not to enforce different policies but to reap personal gains. "The Greek state is huge yet hollow," write two academics in a recent book, "It intervenes in all aspects of social and economic activity, yet, at the same time, it has been taken over from within by groups that prey on the national welfare in the same way the Vikings preyed on European societies a few centuries ago."

One of the main criticisms that the left has been directing all of these years against capitalism is that capitalism puts markets above people. At the same time, the left believes that political intervention is needed to restore the people to their rightful place. Lifting them, that is, from the tragic position as slaves of the market to the glorified position of lords and masters of the market. What makes the case of Greece interesting is that Greece can be said, in a certain sense, to provide the perfect realization of the left's vision of putting people above markets. Greek politicians have always placed people (their clients) above markets, with results we can all see today.