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Greece and the national moral hazard problem

By Alberto Mingardi 2:29 PM 07/01/2011

The genius of politics often consists in disguising obvious facts. When it comes to Greece, a few facts should be clear.

Greece's debt is projected to reach 150% of GDP in the next three years. Its goods markets are considered the most heavily regulated among the 30 member countries of the OECD. Its public institutions are opaque and widely believed to be corrupt. Although Greece's tax rates are slightly higher than the European Union average, the revenues collected are 7 percent of GDP lower.

Furthermore, the public sector is both dysfunctional and amazingly large: the Greek finance ministry estimates there are 700,000 public employees in the country, but others point to a staggering figure of over one million. This would mean that over a quarter of the Greek workforce is on the government payroll.

Greece clearly needs to embrace the difficult path of reforms — such as the European Central Bank's recommendation of privatizing state assets worth 25% of GDP — whatever happens with its immediate debt restructuring. But could such a path toward economic sanity be politically sustainable?

The widespread protests in Greece suggest that the Greeks do not understand why the nation is in such a mess and consider austerity an undue interference by supranational institutions.

The austerity package itself is not above criticism: Greece Central Bank Governor Georges Provolous has commented that it "doesn't give enough emphasis to cutting expenditure," focusing instead on squeezing more tax revenue out of the few Greeks who actually pay taxes now.

However, the government is standing firm, taking full blame for the measures it is adopting, and it is no longer sinking in the polls. Greek public opinion may be less blind to the country's problems than the international press suggests. Rallies and protests are typically organized by minorities, and this seems to be the case in Greece.

What about the rest of Europe? In a way, the most surprising element of the Greek disaster is that taxpayers in other European countries aren't outraged at being called to rescue an economy that has been marching towards disaster for so long.

The legitimate fear of contagion affecting other European countries is now being used to persuade the electorates outside Greece that: first, Greece has not manufactured its own fate, but is rather the victim of "locust-like" speculators and, second, a Greek bailout would be an indictment of the European social model, that is, the welfare state.

Where European public opinion is collapsing under its contradictions is in the attempt to reconcile the idea of the EU as the ultimate policeman of public finance with the ideological need to save the "European social model" no matter what. If the European Union has long been a major catalyst for reform in member states, it seems inappropriate that it now aims to artificially remove the ultimate incentive for fiscal wisdom: the possibility of a sovereign default. The problem of "moral hazard" should not be considered the exclusive preserve of too-big-to-fail banks; countries can suffer from it, too.

To be sure, the European welfare states are different in terms of architecture and incentives; but politics has symbolic elements, and many defenders of the European model seem to think that any questions about the sustainability of the "European social model" should be ruled out of the public debate as soon as possible.

This is in sharp contrast to attempts to restore sanity in public finance, and goes hand-in-hand with short-sighted political considerations. European political leaders, including right-wingers such as Italian Prime Minister Silvio Berlusconi, now regularly talk about market operators as "locusts." That rhetoric may calm the electorates in the short term but will soon leave them lost and misdirected.

Forced to face the truth, Greece just might, paradoxically, end up better off five years from now than countries where the political classes are disguising the need for reform.

An enormous growth of the state at the expense of the private sector is not exclusively a Greek problem. In the case of Italy, the Keynesian bonanza of the 1970s, together with several long-term dysfunctional features of the political system, led the political class to see public employment as an instrument to pursue social policies. No wonder the country has been living, for the past 20 years, in sort of a permanent fiscal crisis that has finally led governments both from the left and from the right to commit to some sort of fiscal tightening.

Nonetheless, instead of fundamentally reforming Italian institutions, Italian politicians are going for a piecemeal reform process that is incomplete and incoherent. On top of that, the Italian political system is now more confused than ever, and blinded by an insane partisanship. If push comes to shove in Italy, it is difficult to speculate whether we will have a government strong enough to push a plan like the one devised for Greece.

The Greek disaster entails some useful lessons for the rest of Europe — exactly the kind of lessons that should bring taxpayers of these countries to resist pressure to condone sins and to demand a fundamental restructuring of public expenditure.

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