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Terence Corcoran: How to save Europe
Posted: May 19, 2010, 7:18 PM by NP Editor
Terence Corcoran, euro, Greece, European Union, bailouts

Supply-side tax changes and debt default are better options for Greece

From the *Financial Times*, Sat., May 8: "European banks in bonds plea: Europe's banks yesterday make a desperate appeal for the European Central Bank to buy the bonds of crisis-hit eurozone members." Yesterday, the banks and other investors got their bailout wish. Following a great circular path, the first wads of cash flowed from the ECB to Germany and other euro governments, which then shipped figurative armoured trucks loaded with euros to Greece, where €8.5-billion was immediately unloaded and transferred into the pockets of bankers and bondholders. That's euro-finance in action.

The 10-year bonds redeemed yesterday were first issued back in 2000, a year before Greece joined the euro. Bloomberg reports that Greece's debt then was already 103% of GDP. But never mind. Greece had been awarded the 2004 Summer Olympics only three years earlier, and it needed lots of new debt to fund the project and maintain its bloated welfare state and corrupt political system. At the time, also, Greece was on the brink of joining the eurozone, an event hailed by all as a crowning achievement of the New Europe. Greece's debt later soared to more than US$600-billion, or 133% of GDP — a big number for a country whose population is roughly the size of Michigan's.

How long will Europe's taxpayers stand by while their governments ship cash through to banks and bondholders who recklessly loaned money to a subprime Greek government that clearly did not have the capacity to pay it back? How long will taxpayers in France and Germany allow their

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May 14, 2010 - After 13 years of Labour government, voters in the United Kingdom have turfed prime minister Gordon Brown — and now they have an unprecedented Conservative/Liberal-Democrat coalition on their hands, under a new Prime Minister, David Cameron. National Post political columnist John Ivison joins host Chris Selley discuss whether the government can survive the austerity measures necessary to haul the country out of hock, and whether Canada — where "coalition" is a four-letter word — can learn anything from these developments.

pockets to be picked to rescue bankers, while Greeks are threatening more riots and a general strike to keep the banker bailouts coming?

Under the Greek rescue package announced last week, the armoured trucks will keep running as often as needed as debt matures over the next three years. After that, who knows? University of Chicago finance professor John Cochrane pointed out in *The Wall Street Journal* this week that these transfers to holders of Greece's existing debt let bondholders and banks off the hook. "Greek bondholders are not being asked to miss a single interest payment, reschedule a cent of debt, suffer any writedown, take a forced rollover or conversion of short- to long-term debt, or any of the other messy ways insolvent sovereigns deal with empty coffers."

In an effort to offset the obviously hopeless optics of the bank bailouts, Germany and other members of the eurozone have mounted a campaign against "speculators," ratings agencies and the investment markets in general. "In some ways, it's a battle of the politicians against the markets," said German Chancellor Angela Merkel. "I'm determined to win," she said. "The speculators are our adversaries." To curb speculators, Germany imposed a ban on naked short-selling of credit-default swaps, while the European Commission's markets commissioner, Michel Barnier, declared war on ratings agencies. Other officials planned to hedge in hedge funds and private market players.

The predictable result was more market chaos, and predictions of more to come. Following the current policy directions now being adopted in Europe, one of two extreme and undesirable events are likely: Either the euro will begin to unravel, or the European Union will become a monster regime with an all-powerful European government built around an expanding debt-burdened welfare state and central control of national fiscal regimes. Both prospects should be enough to bring Europeans to their senses over Greece.

As Prof. Cochrane says, Europe's wealthier countries "simply cannot borrow or tax enough to cover Europe's debts and looming deficits." The only viable alternative is to begin to allow Greece to default on its maturing debt and begin a restructuring. That means banks and bondholders get less than 100¢ on the euro, ending the absurd front-of-the-line payouts now taking place at taxpayer expense. Restructuring would mean some rough times for bondholders and banks, and for the European banking system. But those risks look tolerable compared with the extreme bailout options now being contemplated.

Greece can also do a lot more to reform its tax and spending mess. Steve Hanke, professor of applied economics at Johns Hopkins Univesity, says that in addition to reworking its debt, there are a couple of relatively simple supply-side tax moves that could help Greece overcome its fiscal crisis. In a recent Cato Institute briefing, Mr. Hanke said Greece should begin by "eliminating its massive payroll tax." The tax, used to finance Greece's wild welfare and entitlement regimes, accounts for 22% of Greece's wage bill and 8% of GDP. The supply-side benefit would be to make the Greek economy instantly more competitive.

At the same time, Greece should adjust its value-added tax (VAT) system, and set the rate at the same level for all goods and services. The top rate, recently raised from 19% to 21%, exists side by side with two other lower rates. By eliminating the lower rates, the Greek treasury would collect enough money to offset a healthy part of the lost payroll tax revenue. By Mr. Hanke's calculations, the VAT and payroll tax reforms would be neutral over time, but the impact on the economy would be dramatic. "The incentive effect is huge," he said. It would be equivalent to a 40% to 45% devaluation in the Greek currency, if it had a currency. There is no need to burden the rest of Europe with Greece's debt.

Whether Mr. Hanke's numbers would work out exactly as he predicts, its an approach to the euro crisis that, along with debt revaluations, offers a lot more promise than the dangerous options now taking shape. There are ways to end this crisis without either destroying the euro or creating a national superstate.

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