The Australian

Pain ahead for indebted Europe

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A SPECTRE is haunting Europe: the spectre of public debt. The debt-to-gross domestic product ratio for the European Union is projected to reach 80 per cent this year. Some recent growth in public indebtedness reflects weak economic conditions, but structural budget deficits have also increased sharply.

European governments have now committed to reversing course. But budget deficits are merely symptoms of the problem, not its cause. Fiscal crises are always political in character. With little prospect of any change in the political dynamics, Europe's fiscal woes are here to stay.

The heart of the problem is that Europe's political systems are trapped in zero-sum games, with powerful veto players who can protect themselves from bearing a higher share of costs. Faced with those vetos, the burden of paying for public expenditure has been shifted on to the only party that could not refuse: future generations of Europeans.

That this should be especially acute in southern Europe is not surprising. Greece, Italy, Spain and Portugal have fragile political systems that share a common authoritarian matrix. Difficult transitions to democracy occurred in Greece, Spain and Portugal as late as the 1970s; Italy's two decades of fascism ended with the fall of Benito Mussolini, but the republic that followed was already floundering by the early 60s. A legacy of strong communist movements and of weak, corrupt bourgeoisies has resulted in states that could only manage conflict by buying off the warring parties.

That buying-off was based on four elements. First, particularly after the industrial unrest of the late 60s, labour market regulations entrenched union power while shutting young people and older workers out of the labour force. Second, as rigid labour markets undermined productivity and fed excessive wage claims, greater, increasingly opaque subsidies were provided to businesses. Third, as subsidies proved insufficient to maintain private sector jobs, public sector employment and the pension system were expanded, locking in entitlements to future public expenditures. And fourth, governments tolerated erosion of the tax base through tax evasion and the growth of the black economy.

Inevitably, the outcome was a loss of competitiveness. But until those countries' entry into the euro, that could at least partially be offset by periodic devaluations. These were followed by bouts of inflation that eroded the real value of pensions, public sector wages and public debt. Yet inflation imposed growing costs of its own, as expected future price increases led to spiralling wage demands and rising interest rates.

This was the vicious cycle the euro was intended to break. Far from being modelled on the economist's concept of an optimal currency area, European monetary union was designed as a straitjacket for political systems that could not manage themselves.

However, the fiscal rules supposed to underpin that discipline have lacked credibility.

Germany and France, the pillars of the system, faced spending pressures of their own. Reunification and generous social transfers weighed on Germany's budget position. As for France, not once since the collapse of Gaullism in the late 70s has it run a budget surplus; and even Nicolas Sarkozy, having preached fiscal responsibility, has presided over rising structural budget deficits, so that France's debt-to-GDP ratio will hit 100 per cent by 2013.

Neither country could plausibly trigger against others the draconian penalties European treaties provided for breaching the fiscal constraints.

As promised disciplines evaporated, political change added momentum to unfunded public spending. Communism's

collapse loosened party loyalties, making European politics more volatile. And new issues, notably immigration, weakened existing parties. Finally, corruption scandals reduced the political system's credibility, inducing voters to view politics as little more than a struggle for spoils. Retaining political power became increasingly dependent on providing benefits while allowing crucial constituencies to avoid costs.

Southern Europe led the way but it wasn't alone. Nor was the resulting deficit syndrome limited to the euro zone, as Britain's burgeoning public debt attests.

Can the situation be turned around? History shows that durable fiscal consolidation involves cuts to public expenditure, rather than increases in taxation. Such cuts are not impossible. After all, between 1995 and 2006, general government expenditures as a share of GDP declined by 10.8 percentage points in Sweden, 8 percentage points in Denmark and 12.7 percentage points in Finland. But two conditions must be met.

First, the political system must manage the terrible asymmetry between fiscal expansions and contractions. Expansions provide concentrated and immediate benefits in exchange for diffuse, postponed, costs; contractions impose concentrated, immediate costs in exchange for benefits that seem remote and uncertain.

Little wonder the Rudd government, rather than cut back on the gravy train of its stimulus spending, has gone for higher taxes, notably on mining. For far weaker governments, in countries where those being asked to shoulder the costs do not believe they will share in the benefits, the challenge is much greater.

Second, the macroeconomic consequences of fiscal consolidation depend crucially on whether it allows reductions in real wages, which can increase private sector employment, cushioning reduced public spending. Devaluation can help by cutting domestic wages in foreign currency. But it is never sufficient.

Rather, labour market insiders, who could offset devaluation by seeking wage increases, must be persuaded to accept real wage falls, either by agreement or by weakening their bargaining position. But in large parts of continental Europe, unions are neither willing nor able to co-operate in economic reform.

Consolidation, if and when it comes, is therefore likely to be prolonged and painful. How far the costs will extend, and with what impact on the rest of the world, remains to be seen.

With uncertainties also looming about China, this makes it crucial our economy can handle uncertain times. Where better to start than by restoring flexibility to our labour market, imposing disciplines on public spending and protecting Australia's reputation as a safe place to invest?

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