Lessons from Greece for the United States

By: Peter Morici

As the Flash Crash in U.S. equity markets May 6 illustrated, problems in Greece can have grave consequences for not merely other Mediterranean economies and Europe, but U.S. and the broader global economy.

The sell off on Wall Street May 13 and 14, in the face of strong U.S. economic data, reflected growing concerns that the Euro Zone bailout will not work—Greece may be beyond saving—and that European government finances don't work.

At its core, problems in Greece reflect broader problems in Europe that are spreading to the United States. The 750 billion euro assistance fund simply does not address those problems. It is perhaps a palliative, not a cure.

Outsized Expectations for Public Benefits

In Europe, voters expect a strong, broad and expensive social safety net—including universal health care, income security and early retirement—those benefits until now exceeded in many instances what is provided by governments in North America.

This safety net has so reduced risks to individual and rewards for initiative and entrepreneurship that the safety net has slowed population and economic growth to dangerous levels.

Slower population and economic growth has made the social safety net too expensive to sustain in rich countries and poor countries alike.

With the commercial integration that followed World War II through the European Common Market, composed initially of only six nations, and the broader European Free Trade Area, which encompassed most of the non-communist states, public expectations for benefits in poorer nations and regions, like Portugal, Greece and southern Italy, grew to rival those in richer states. This despite the fact their economies lacked the resources to pay for those benefits, even more acutely than in Germany or France.

Politicians responded by expanding and enriching social safety nets but costs rose too, as doctors, teachers and the like expected salaries and benefits more comparable to their colleagues further north.

The price tag outran the ability of employers and governments to pay, and inflation and national budget headaches followed.

Continued.....

Until the euro was adopted in 1999, southern nations would let their national currencies gradually fall in value against the German mark and other currencies of richer nations.

That boosted exports and tax revenues. The pensions paid by Portugal, Greece and others became worth less if spent in Germany and other northern jurisdictions, while these Mediterranean states became great places for Americans and northern Europeans to vacation and retire.

After 1999, national governments in Spain, Portugal and Greece, and to a lesser extent more prosperous Italy, faced the difficult prospect of telling their citizens they could not retire as young, enjoy the same health benefits or employment security as the wealthier French, Germans and Dutch.

Instead, these governments borrowed heavily and now face severe retrenchment and perhaps eventual bankruptcy.

The Teutonic austerity Germany and others will compel to bail out these floundering governments will shatter the myth that the welfare state can be provided equally across Europe, or Mediterranean states will simply quit the euro and take with them the Franco-German dream of European Unity.

Before we chasten our Mediterranean friends too harshly for living beyond their means, remember northern reluctance to share wealth through a strong central government has much to do with their predicament.

In the United States, the states can't print money and some spend more aggressively than others but most social benefits are substantially assisted by Washington, which can tax New York to subsidize Mississippi. Brussels cannot tax Germany to help pay for Greek social benefits, at least as aggressively as needed.

Unless Germans and others are willing to let Brussels tax them as necessary to reasonably equalize social spending between richer and poorer states, the euro will remain an uncertain adventure and European unity a utopian dream.

The Threat of Contagion and the Future of the Euro

The 750 billion euro bailout is creating concerns in several dimensions.

Greece and perhaps the others may be beyond the tipping point. Even with moderate growth (that's the most we can hope for in this climate), no combination of austerity measures may be possible that would resolve Greece's financial problems. It simply will have to restructure its debt—sovereign speak for default.

That could have huge ripple effects, because the Portuguese, Spanish and several other governments would face much higher borrowing costs and much greater prospects of default. European banks, including those in Germany and other wealthy jurisdictions hold sizeable amounts of threatened countries' debt, and U.S. banks hold a lot of European debt.

Crisis could easily spread from Europe to the United States, much as the recent U.S. mortgage and broader financial crisis spread to Europe.

Continued.....

The European Central Bank is stepping up by buying sovereign debt, and with restructuring on the wings that could amount to simply replacing Greek and other sovereign debt with billions of euro and inflation.

At the end of the day—the combination of existing debt and public expectation for the minimum social safety net (health care spending, retirement benefits, baby bonuses, etc) may compel Germany and other richer countries to choose between Greece and other poorer countries quitting the euro—returning to their own currencies—or a combination of high inflation and greater fiscal union in the EU. Regarding the latter choice, either the North subsidies the South through ECB printing euro and inflation, or the EU transfers tax revenues from richer to poorer countries.

The Germans rightly fear hyper-inflation, and a EU take over the social safety net by granting it taxing authority over the entire EU to finance it is unlikely. Instead, countries like Greece may be forced to leave the euro zone or the euro will disappear all together. This could take several years to play out.

Lessons for the United States

The U.S. federal government and many states face similar difficulties but for the fact that the United States prints dollars—the global currency—but that could change.

The budget published by the Administration contains optimistic assumptions about economic growth from 2011 through 2015—in the range of 4 percent—when most private economists think something less is likely.

It contains the politically less difficult fiscal levers—repeal of the Bush tax cuts for families earning over $250,000, and the estimated revenues and costs of the new health care law were in line with CBO estimates for what ultimately emerged, including the interest and dividend tax.

More realistic assumptions about growth and the cost of health care put U.S. projected deficits on the path to unsustainability—more than $1 trillion a year for many years. Hence a value added tax is now on the table.

In the current environment of indiscipline, a VAT would be a disaster.

The polemic is appealing. Other industrialized countries have one, now that U.S. social benefits are more like those with the passage of national health care, the United States should have one too?

Not so fast.

Europeans pay a VAT and have income and corporate taxes too but they pay little for health care and higher education—the government uses those taxes to pick up the tab.

With a VAT, U.S. individual and business taxpayers would have tax burdens comparable to Europeans but would still face hefty bills for private health insurance and college tuition that Europeans do not bear.

Continued.....

The reason is simple. Americans pay 50 percent higher prices for health care services than the Germans and other most other Europeans, and U.S. universities are hardly hubs of modern efficiency.

The recent health care law contains firm commitments about scope of coverage and benefits guaranteed each citizen, but it is soft about bringing down higher U.S. drug, medical professional fees, administrative costs, and malpractice costs into line with Europe.

U.S. governments, federal and state, pay for about half of U.S. health care expenses, and a VAT would take away the pressure to chisel down to size the price of drugs, physicians fees, etc to make health care affordable.

U.S. higher education is another big hole in household and state finances. We are paying too much for what we get, except perhaps from our most modest institutions—community colleges.

A VAT, without offsetting cuts in personal and corporate taxes, will only make Americans poorer and with fewer incentives to work and innovate than the Europeans now have, cause businesses to offshore even more jobs and tax economic growth to anemic levels.

Without a VAT and absent real and substantial cost cutting for health care and provision of other public services, budget deficits will drive up U.S. borrowing costs to unmanageable levels.

With a VAT and no real cost cutting, the absence of growth will strangle American prosperity.

Greece is a warning to governments that promise too much and pay too much for what they promise.

The United States is hardly free of such folly.

Peter Morici is a professor at the Smith School of Business, University of Maryland, and former Chief Economist at the U.S. International Trade Commission.