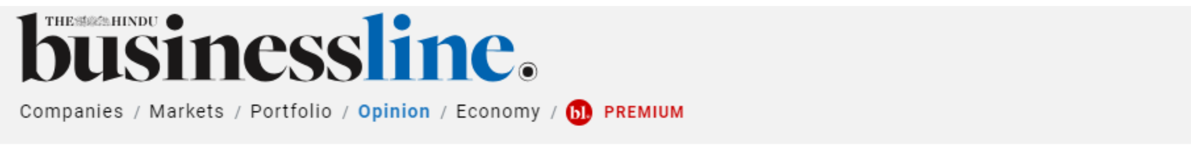

Europe gaping at a lost decade

PREMIUM

Updated - March 09, 2018 at 12:50 PM.

Europe cannot afford to abandon austerity and run big deficits, when its growth prospects are weak.

BY NILANJAN BANIK

The European economic crisis is back again at the centrestage of all economic discussion. During an economic crisis, consumers spend less, and investors do not invest (or postpone their investment decisions). There is a general sense of pessimism about future earning prospects, leading to higher unemployment and lower productivity growth — something that is evident in present day Europe.

In order to understand this crisis, we have to step a little back into history. Soon after the Second World War, when Europe was devastated, policymakers in the region wanted to re-build Europe on the premise of socialist capitalism. The underlying idea is that when the market is at a nascent stage, the state will ensure that a labour market comes into play and jobs become available. For the elderly, and those without jobs, the state will take care through a benevolent social security system — paying unemployment benefit and pensions.

Noble system, falling growth

The objective is noble, but to make the system efficient the government has to ensure that it collects funds through taxation to pay dole for the unemployed and pension for the retired. Dole and pension are expenditures for the government, and to pay for it, the government has to collect taxes.

The principal source of tax is corporate income tax (contributing to nearly 80 per cent of the total tax collection), indirect tax (such as excise and service tax) and direct income tax (that is, taxing the working class).

At the time of recession when businesses are not forthcoming, or when people find it hard to get a job, it is quite natural that tax collection will be inadequate. Therefore, the government will meet its welfare objective (that is, to pay for dole and pensions) by printing money or by borrowing. Both are perfect recipes for increasing the budget deficit and the public debt.

A higher budget deficit can be sustained, provided the economy is growing. However, economic growth is continuously falling in the Euro Zone — 3.4 per cent during the 1970s, 2.4 per cent during the 1980s, 2.2 per cent during the 90s, and 1.1 per cent between 2001 and 2009.

A reason for this is lack of institutional reforms. In a socialist capitalist structure, wages are protected by trade unions. This is irrespective of labour productivity and firms' ability to earn profit. Add to this, is Europe's ageing population, which is likely to increase further in the future. To maintain a stable population, 2.1 children should be born to each woman in an economy, assuming an average death rate applicable to the world's population.

In contrast, the figures for some Euro-Zone economies are much lower: 1.38 for Greece, 1.39 for Spain, 1.41 for Italy and 1.94 for the UK. For Spain and Greece, the over-65-year population will increase from around 17 per cent now to 25 per cent by 2030. The bottomline: Europe has fewer younger people to work, to pay for the expensive welfare programme.

WAY OUT

A natural suggestion would be to reform the labour and pension laws (dubbed as austerity measures), and slacken the immigration laws. But, if the recent poll results are any indication, it seems voters in France and Greece do not like reforms, and would rather punishing the parties in favour of austerity measures.

A closer look at European democracies suggests it is run by the insiders made up of pensioners, trade union leaders, public sector workers and

big farmers. The outsiders consisting of small numbers of immigrants, the youth and small private entrepreneurs have little say.

Threat to eu

It is a classic case of a socialist democracy in which the insiders are myopic, care too much about present benefits, and are deliberately voting parties to power that support their cause. On the contrary, the outsiders are quite powerless.

Even issues such as changes in labour immigration laws are stalled. A flexible labour immigration clause is expected to resolve issues related to the dearth of a young skilled labour force. The brain drain from developing countries such as India and China has helped fuel economic growth in the US, but not in Europe.

Lack of austerity measures in the form of institutional reforms is reflected in the form of the ever-increasing debt to GDP ratio. Cumulative public debt as a percentage of GDP for most of the Euro Zone countries is already more than 100 per cent — 120 per cent for Italy, 160 per cent for Greece, 105 per cent for Ireland, and 107 per cent for Portugal.

Besides, dissimilar macro-economic conditions (reflected in the debt-GDP ratio) may even threaten the existence of the European Union (EU). This is because it renders a common macro-economic policy — expansionary monetary/fiscal policy during a recession and contractionary monetary/fiscal policy during an expansion — ineffective. But Europe is diverse, and when Greece is facing recession and Germany is doing well, then following an expansionary monetary policy may help Greece but will heat up the German economy.

It is precisely for this reason that countries willing to join the EU were expected to display similar macroeconomic indicators. It was decided only those countries that have a budget deficit less than 3 per cent of GDP and a government debt-GDP ratio of less than 60 per cent will be allowed to become part of the EU.

However, a few countries such as Greece, Italy and Belgium, with debt-GDP ratios of more than 120 per cent, resorted to creative accounting to become a member of the Union.

We are now faced with the results, with demand management failing miserably, and the euro trading at an all-time low.

It will be to Europe's benefit if the nations prepare themselves for austerity measures. Otherwise, like Argentina during the 80s and Japan during the 90s, a lost decade will be a reality for Europe.

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