

**The Center on Capitalism and Society
Columbia University
Working Paper No.87, Revised September 2015**

What Ails Greece? The Two Perspectives in Macroeconomics

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September 29 2015

Abstract

Greece's failed economy is attracting the attention of a great range of economists. Some prominent economists adopt the reductionist theory that the rewards sought from a nation's economy boil down to employment -- and employment is determined by "demand." They say that a fiscal shift to a newfound "austerity" has decreased demand and thus depressed employment. But the evidence does not verify that austerity is the main cause. We must not be obsessed by a monistic theory of everything. A fuller understanding requires more than one model. It would be useful if economists would draw on the modern idea that a person's rewards from work in the nation's economy derive, directly or indirectly, from entrepreneurial and innovative activity. Greece's problem is that it is sorely lacking in that.

What Ails Greece? Two Economic Perspectives

by Edmund Phelps*

The recent clashes of opinion on Greece's much-discussed ordeal highlight some fault lines in present-day economics. The discussion reveals differing perspectives on what people want from their economies. From one perspective, every economy is a mechanical instrument. In Greece, it has been used to provide jobs, social benefits and public investments. Now, as some economists see it, financial burdens prompting fiscal "austerity" have thrown a monkey wrench into the machine, causing a drop in "demand," hence a drop in jobs, benefits and capital projects. The *mechanists* would fix Greece's economy by restoring demand.

But an economy can be an organism that people – exploring, experimenting, imagining and creating – cultivate in efforts to develop new goods and gain new experience in the process. What economists taking this view perceive in Greece, though, is a host of barriers to competition,

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Part I is a version with footnotes of an op-ed published in Project Syndicate on August 6, 2015. It expands upon a short piece published in *World Post* as well as *Huffington Post* on June 13, 2015 and an interview alongside Paul Krugman on Bloomberg's "What'd You Miss" aired the same day. It responds to objections and it adds points made by others.

Part II is a version with footnotes of the sequel in Project Syndicate on September 4, 2015.

entrepreneurship, start-ups and change that block new goods and experience. The *structuralists* would unlock Greece's potential by removing barriers.

Yet the mechanists offer precious little evidence for their austerity thesis on Greece and the structuralists have not shown even circumstantial evidence that entrepreneurship and innovation are blocked in Greece. This paper reviews the two theses and tests them against evidence.

I

Overlooking the modern idea that a nation's prosperity derives from innovation and entrepreneurship, the mechanists view prosperity as a matter of output and employment, which are largely determined in turn by "demand" – government spending, consumer demand and investment demand, all of which need to be financed.

Regarding Greece, this demand school says that a shift of fiscal policy to "austerity" – a small public sector – has brought a deficiency of demand, which depressed employment. But this claim misreads history and exaggerates the power of government spending.

Much of the decline of employment occurred *prior* to the sharp cuts in spending between 2012 and 2014 – owing, no doubt, to sinking confidence in the economy before the cuts. The evidence:

- Greek government expenditure per quarter climbed to a plateau of around 13.5 billion in 2009-2012, then fell back over 2013 to around 9.6 in 2014-2015. Yet employment had been at a high of 4.5 million in 2006-2009, then fell over 2010 and 2011 to 3.6 in 2012 to the present.¹

Evidence on unemployment reinforces that finding. The unemployment rate had almost risen to its recent level of around 25.5 when the budget cuts were just beginning.

- From a normal level of 9.6 percent in 2009, the unemployment rate rose to 12.7 in 2010, to 17.9 in 2011 and to nearly 24.5 in 2012.

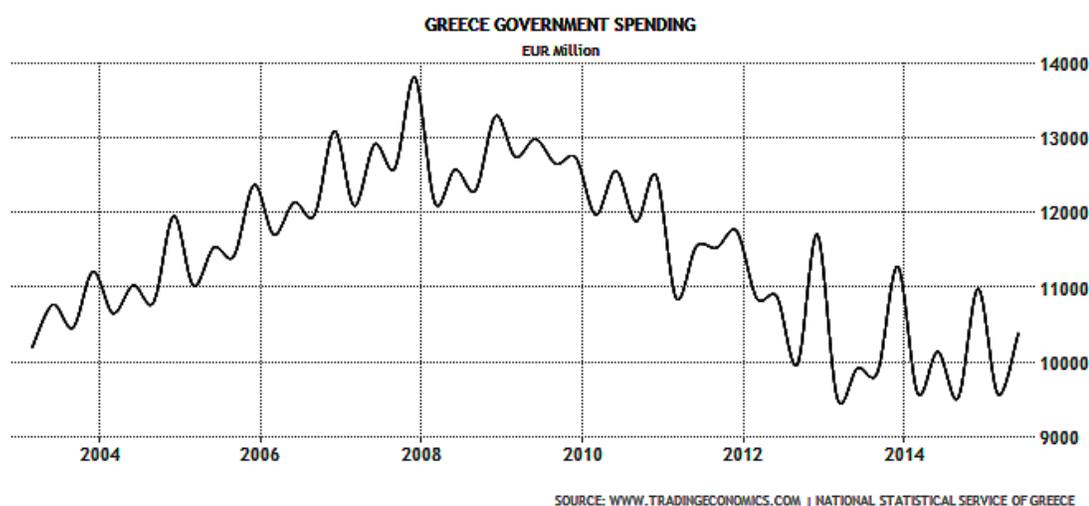
These findings weigh heavily against the hypothesis that “fiscal austerity” has brought Greece to its present plight. They indicate that Greece’s turn away from the high spending of 2008 to 2013 is not to blame for today’s mass unemployment. Evidently the demand school has wildly overestimated the role played by fiscal policy.

¹ Eurostat, General government expenditure, annual data, extracted 27 July 2015, and Trading Economics, quarterly data, extracted 27 July 2015. General government expenditure in percent of GDP was around 54 in the period 2009-2012 and, after a brief rise, nosedived to 49.3 in 2014.

Another finding puts in doubt the very *presence* of fiscal austerity.

Government spending has certainly fallen, but only back to its accustomed neighborhood.

▪After its fall, rise, and fall, government expenditure – at 9.6 billion euros in first quarter 2015 – still exceeds its level of 2003 and earlier.²



It might be wondered whether the observation that government expenditure fell back to its pre-boom neighborhood, not to new depths, misses the possibility that productivity strongly rose over this span and that could have been positive for output and negative for employment, so that government expenditures would have had to *rise* strongly too just to keep employment from falling. However, it does not appear that government expenditures have shrunk relative to the gross domestic product.

² Archival data from Eurostat available at tradingeconomics.com A chart shows the below-average spending, 2001-2008, and the above-average spending, 2010-2014.

▪After its fall, rise and fall, this spending – at 49.3 percent of GDP in 2014 – is back to its level in 1997-2000. The mean level in 1995-2014 is 49.44 percent.³

So the austerity thesis appears wrong in its very premise.

It could be argued that the fiscal deficit and public debt are better measures of stimulus than the level of public expenditure is. But the austerity thesis fares no better on these measures.

▪The deficit was 10.2 percent of GDP in 2011 and hit 12.3 percent in 2013.

▪Public debt reached 175 percent in 2013.

So there is much evidence that Greece has *not* departed from past fiscal norms: it has only returned to them after the splurges of earlier years. It is unhistorical to speak of present-day government spending as “austere.” It would be more fitting to view Greece as having moved away from wayward years of fiscal profligacy. Though it still has some distance to go: even now, the government is running a fiscal deficit of 3.5 percent.⁴

The demand school might reply to all this that their basic contention – whether or not fiscal austerity is present – is that increased government

³ Archival data from Eurostat available at tradingeconomics.com A chart shows the below-average spending, 2001-2008, and the above-average spending, 2010-2014.

⁴ Eurostat, General government gross debt. Date of extraction 24 July 2015.

spending, financed by fiscal deficits, would impart a permanent lift to employment. However, the recent experience in Greece suggests otherwise:

- Following the huge rise in government spending from 2006 to 2009-2013, there were gains in employment, but these were not sustained.⁵

But the real sticking point is that Greeks would have to save the extra income from the increase in government spending to buy the government's bond issues financing the extra spending – supposing there was a limit to the bonds foreigners would buy. And in an economy unequipped for growth, household wealth relative to wages would soar and the labor supply would shrink, contracting employment.

So spending more is not the remedy for Greece's plight, just as spending less was not the cause. As the Italian economist Luigi Bonatti said in a recent letter, to claim that one can address Greece's structural stagnation with Keynesian policies is ridiculous!

Similarly, debt restructuring, even debt forgiveness, would not suffice to regain the elevated levels of employment, social services and capital projects

⁵ Eurostat, General government expenditure, annual data, and Trading Economics. A roughly one billion euro jump of government spending per quarter – the rise of quarterly government spending from around 11.8 billion euros in the first half of 2006 to around 12.9 billion in 2009 – was followed by a rise of employment 4.52 million in 2006 to a peak of 4.61 million in 2008. The unemployment rate fell from around 9.0 percent in 2006 to a low-water mark of around 8 percent in 2008 and was back to 9.6 percent in 2009.)

that resulted from the European Union's gift of structural funds from 2007 to 2010. And it would fail dramatically to unlock Greece's potential for innovation – for discovering new goods and gaining the experience of personal achievement and personal growth. It would only help Greece revive its government spending level.

It is time that economists begin to consider the structuralist perspective on the potential of an economy and how it has been blocked.

II

From the structuralist perspective, Greece's public sector is rife with *clientelism* to gain votes and *cronyism* to gain favors – far more so than in most of Europe.

- Maximum pension for state retirees relative to wages is nearly twice as high as in Spain.⁶
- The government favors business elites with tax free status.
- Some state employees are found not to have to report for work.

From this same perspective, there are serious ills in the private sector, too, notably the pervasive influence of vested interests and the country's business

⁶ International Social Security Association, *ISSA, Social Security Country Profiles*.

and political elites. Competition between companies for increased market share is weak and firms with new ideas bearing new ideas are few. Evidence:

- Profits as a share of business income were a whopping 46 percent according to the last reported data. Italy came in second at 42 percent and France third at 41 percent. (Germany was at 39, the US at 35 and the UK at 32.)⁷
- Insiders receive subsidies and contracts, making it all the more difficult for outsiders to start up competing companies.
- Young Greek entrepreneurs reportedly fear to incorporate their firms in Greece lest others use false documents to take away their companies.⁸
- The World Bank rates starting a business in Greece to be harder than anywhere else in Europe.⁹

This stunted system springs from Greece's corporatist values: social protection, solidarity instead of competition, and discomfort with uncontrolled change. These values may well be beneficial for family life, but, even with the best of intentions, they are a recipe for a static economy and stultified careers.

Greece's system performs far below the others in the European Union – the earliest 15 members at any rate.

⁷ OECD *Economic Outlook* December 1998, Annex Table 24, p. 214. 1997 is the final year.

⁸ This hole in Greece's property rights is reported by Peter Jungen, who learned of it in talking with young Greek entrepreneurs at a meeting on the island of Hydra.

⁹ World Bank, *Doing Business*.

- Labor productivity – GDP per worker – in Greece is around 72 percent of that in Britain and Italy; and 57.7 per cent of that in Germany and Ireland.¹⁰
- Surveys report that mean life satisfaction in Greece is far below the EU15.

And while Greek governments suggest their corporatism serves the less advantaged, in fact it impoverishes them.

- EU data on poverty rates in 2010 put Greece at 21.4 per cent – far higher than the mean EU15 rate of 16.7.¹¹

Greece's system blocks the two main sources of broad prosperity. One is an abundance of entrepreneurs engaged in detecting and exploiting new economic opportunities – Hayek spoke of *adaptations* to “changing circumstances.” On adaptation, Greece looks very poor.

- Productivity and wage gains since the postwar catch-up have resulted mostly from gains in education and capital per worker, not from seizing opportunities.¹²
- Greece's much-lauded shipowners, for example, were too slow to adapt to containerization and thus lost market share.

¹⁰ Compendium of Productivity Indicators 2015 © OECD 2015

¹¹ Eurostat, EU-SILC. Poverty rates in EU countries. 2011 (based on 2010 incomes).

¹² The World Bank, *Golden Growth*, 2012, Washington D.C., p. 40. In the standard analysis, wage growth may be decomposed into capital deepening, human capital deepening and growth of “total factor productivity.”

The other source is plenty of business people engaged in conceiving and creating all sorts of new products and processes – often termed *indigenous innovation*. On innovation, Greece looks devoid of the necessary dynamism.

- Venture capital investment flows relative to GDP are smaller in Greece than any other country in the European Union.¹³

So Greece's economy has scant ability to create sustained productivity growth and high human satisfaction. On top of that, Greece, like all Europe, has felt the productivity slowdown in America and its financial crisis.

Some mechanist economists believe that these structural considerations have nothing to do with Greece's current crisis – only with long-term performance. Of course, the Greek economy is now dying of a thousand cuts. The structuralist perspective illuminates what went wrong – and why.

For several years, Greece drew on the EU's aptly named “structural funds” and on loans from German and French banks to finance a wide swath of highly labor-intensive projects. Employment and incomes soared and savings piled up. When that capital inflow stopped, asset prices in Greece fell back and demand for labor in the capital-goods sector dropped correspondingly.

¹³ *Going for Growth*, OECD, Paris, 2006.

Moreover, with household wealth having far outstripped wage rates, the supply of labor diminished as well.¹⁴ Thus, Greece went from boom to outright slump.

The structuralist perspective also explains why recovery has been slow. With competition weak, entrepreneurs did not rush to hire the unemployed. When recovery began, political unrest last fall nipped confidence in the bud.

What is to be done, then? The Eurozone creditors can best help Greece by inducing it to rid itself of its corporatist practices in the public and private sectors. The remedy must lie in adopting the right structural reforms.

Such a hope may seem unrealistic. A cynic might think that the latent purpose of the reforms sought by the Eurozone members to date was to raise the chances of repayment of their past loans. However, the members also have a political and economic interest in doing what is best for the development and survival of the monetary union. So they could help strengthen the union by working with Greece to rid it of its corporatist ways. They should also be ready to help Greece with the costs of making the changes.

¹⁴ Greece's wealth-to-median-income ratio belongs in the high group, with Italy, Spain and Belgium, not the low group containing Germany, Austria and Holland. European Central Bank, The Eurosystem Household Finance Survey, Statistics Paper Series No. 2, April 2013.

Greece, though, must drive reform. Current indications are that Prime Minister Alexis Tsipras is willing to take that course. As a media expert, George Pleios, was quoted as saying, “he is showing that he is able to speak the language of reform.”¹⁵ However, he will need a sense of the reforms required. Greece must understand that the task is not simply to dismantle corporatist institutions and practices that obstruct whatever innovativeness and entrepreneurship could arise. For an abundance of imaginative innovators and vibrant entrepreneurs, Greece must embrace a vision of venturesome lives of discovery and creativity – the prospering that comes only from human agency, from individual successes, and the flourishing that comes only with the experience and self-expression found in imagining and creating the new.

So Greece needs more than just debt restructuring or even debt relief. If young Greeks are to have a future in their own country, Greece needs to develop the attitudes and institutions that constitute an inclusive modern economy.

Europe for its part must think beyond the reforms (necessary though they are) of Greece’s systems of pensions, taxation, and collective bargaining. It must examine Greece’s values and its own, too. While Greece has reached the

¹⁵ Suzanne Daley, “Alexis Tsipras, Greek Prime Minister, Sheds His Identity as a Radical,” *New York Times*, 21 July 2015.

heights of corporatism, Italy and France are not far behind – and not far behind them is Germany. Not just Greece but all of Europe must rethink its economic philosophy.