Greece and the Limits of Anti-Austerity

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Is austerity dead? At last month's G-8 meeting at Camp David, the German-led austerity program for the eurozone's troubled southern members ran up against substantial resistance. Likewise, France's recent presidential election bolstered those who argue that Europe must grow its way out of its debt-heavy public sector, rather than aim for immediate fiscal orthodoxy. And there is no guarantee that Greece's newly elected center-right New Democracy party, which favors honoring the country's bailout terms, will be able to form a majority government.

The United States, by contrast, has pursued expansionary and growth-oriented macroeconomic policies since the 2007-2009 financial crisis, despite massive budget deficits. Thus far, judging from the modest recovery in the US versus non-recovery in Europe, American policy accommodation is performing better than European austerity.

But simply choosing between expansion and austerity is not the whole story. Macroeconomic policies interact with on-the-ground microeconomic realities in subtle but powerful, rarely remarked-upon ways. Simply put, Europe's microeconomic structure makes the same growth-based macroeconomic policies less effective in the European Union than in the US.

Here's why: macroeconomic easing, by lowering interest rates or otherwise pumping money into the economy, aims to increase economic activity. With more money moving around, businesses rehire employees and ask existing employees to work more hours. Entrepreneurs considering whether or not to start a business decide to proceed, and their bank lends them the money to make the new business viable.

The newly hired workers and newly formed businesses spend money, which induces more hiring, more start-ups, and yet more spending. The economy grows, yielding higher tax revenues, thereby helping governments to put their fiscal house in order. The country grows its way out of its economic problems.

But the EU cannot realize this scenario as easily as the US can, because micro-level rules in the EU generate friction that slows that kind of an expansion.

The EU's stricter labor rules are a well-known and often-cited example. European labor-market rigidities mean that it is difficult in many EU countries to downsize a company. Anticipating that difficulty, companies are less willing to hire in the first place, until they are sure that long-term demand for their products is sufficient to justify long-term hires. Hence, even if businesses get easier access to money and loans, many firms will still decline to hire on a large scale, fearing that they would be saddled with a large payroll in a future downturn.

For example, *The Economist's* recent portrait of Italian Prime Minister Mario Monti shows that Italy continues to be stymied by labor rules that make businesses reluctant to expand beyond 15 employees (after which it becomes hard for a firm to downsize). To work smoothly, expansive macroeconomic policies require compatible microeconomic rules.

There is some irony in the fact that the strongest proponent of austerity has been German Chancellor Angela Merkel's government, because Germany, particularly under her predecessor Gerhard Schroeder's Social Democrat-led government, did much more to liberalize the country's rules for labor and business than other EU governments. Expansive, growth-based policy could work better in Germany than in many eurozone countries for which it is being prescribed.

Rules that impede business start-ups may be an even more important obstacle to making monetary expansion effective. It is simply too difficult to launch many types of businesses in many places, and to expand those that are started. Necessary licenses are often not routinely obtained. The simple start-up paperwork is still more burdensome than it is in the US. Indeed, while this process has become easier in Europe in recent years, the World Bank estimates that it still takes twice as long to start up a small business in Greece and much of the rest of the EU as it does in the US – and four times as long in Spain.

While the relative absence of Facebook-style mega-entrepreneurial successes in Europe is regularly bemoaned, the difficulties of opening hairdressers, basic retailers, and simple mail-order businesses may have an equally profound overall effect.

Consider taxi licensing. Many people can drive a cab, including many who are unemployed, but not so many can get permission to do so in many major cities in Europe and the US. Imagine much of the economy organized like the taxi industry. Most kinds of economic stimulus won't generate more taxis, until entry restrictions are reduced.

Magda Bianco, Silvia Giacomelli, and Giacomo Rodano, researchers at the Bank of Italy, report that these institutional roadblocks to expansion remain substantial in Italy. A factory might get easier access to funds, and it might see more demand for its products, but, rather than hiring new workers, it might decide to raise its prices. A potential competitor might consider entering that market; but, given substantial regulatory entry barriers, it might ultimately decide to remain in its current business.

Expansionary monetary policy in such an environment might fail. Perhaps for this reason, France's new president, François Hollande, favors using the government to direct specific outcomes – for example, by hiring 60,000 new teachers.

One can imagine a grand bargain in Europe, with expansionary macroeconomic policies coupled with the easing of microeconomic impediments. But existing businesses and already-employed workers prefer the *status quo*, and can powerfully inhibit policymakers. There may be more than a little of this in Greek politics, and that of other EU countries.