The Greek Tragedy and the Political Rules of Fiscal Crisis

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The economic crisis in Greece, which has roiled all of Europe, has been presented by the mainstream media as arising from the mismanagement of economic resources. In fact, the real roots of the crisis and others like it are in the malfunctioning of political institutions.

Politics, according to the famous formulation of Harold Lasswell, is about who gets what, when and how. Although all political institutions produce an answer to these questions, well-functioning ones must produce answers that are, at a minimum, not manifestly irrational (for instance, in the sense that they are worse for nearly everyone than those which some alternative would have brought about) nor manifestly unjust (for instance, in the sense that they systematically favor the already advantaged over the already disadvantaged). However, many political institutions fail to satisfy one or both of these criteria.

One of the most common forms of such irrationality is that the public finances become hostage to a collective action problem involving different influential actors in the society, who treat the public fisc as a common pool resource, seeking to draw the maximum from it while contributing the minimum to it. This collective action problem is not a necessary consequence of the plurality of actors and their interests, although that plurality is a necessary condition for its occurrence. In fact, the crisis of the public exchequer is a reflection of the weakness of the state in relation to the society as a whole.

A weak state is very often, as a matter of description, the ineffective slave of many masters and the ineffective master of many slaves. It is neither the effective slave of some nor the effective master of all. The immediate consequence of this condition is that the weak state can neither effectively raise resources nor effectively spend them. It raises too little to pay for what it spends. It does not raise money where it should and it spends on the wrong things.

When this condition becomes deep-seated, it leads to a self-reproducing cycle, in which the weakness of the state contributes to its weakness. The chronic fiscal deficits to which this political situation gives rise can be readily tolerated if the national economy is able to generate an increase in national income sufficient to counterbalance the increase in the national debt. If not, the state must either attempt to overcome its weakness in relation to the society (even if initially through measures which reveal that weakness, such as the inflation tax) or face the consequence of its weakness, in the form of fiscal crisis. Fiscal crisis in turn implies the necessity of defaulting on debt wholly or partially, or raising revenue and lowering expenditure abruptly. The former may provide a salve (especially if the situation is not so serious that fresh borrowing is needed even to maintain current expenditure) but risks punishment from creditors in the form of higher costs of borrowing and no guarantee that the drama will not be repeated. The latter restores fiscal probity at the cost of generating severe adverse consequences for human beings, and for public investment in national development, while also providing no guarantee that the drama will not be repeated.

From the perspective of the accountant, there are only two routes out of this dilemma. The first is to turn a relatively stagnant economy into a more dynamic one that is capable of growing enough to afford the cost of the broken relationship between state and society. The second is to establish a new relationship between state and society in which the state is both more effective master and more effective slave of the social interests. In practice, these two routes are not independent but are more often than not deeply intertwined. The national economy is relatively stagnant in part because the state cannot act effectively to invest and to create the conditions of sustainable growth. The repair of the relation between state and society is the *sine qua non* of sustainable growth and development.

What of Greece? Greece has had a rate of economic growth that has been respectable and may have sustainably accumulated debt were it not for the change of mood in the global market. To this extent, Greece is not fully responsible for its situation. Nonetheless, it has suffered a collapse of confidence because it was vulnerable to one. Its national economy is unable credibly to promise the extent of future dynamism necessary to reassure its creditors (in part because fiscal constraint will undermine the public investment necessary for future growth and development). The creditors would in turn not have been able to demand that reassurance had Greece not pursued a leveraged path.

Now that the crisis has struck, its golden chains to the Euro prevent Greece from pursuing the low road tactic of nominal exchange rate depreciation as a means of spurring growth. The alternative low road tactic of real exchange rate depreciation (the lowering of real wages and costs) is available to it, but is socially painful in the extreme, and unlikely to be an ultimate solution. Default may also not provide a salve even in the short run, due to the dependence of the Greek economy on borrowing to finance current consumption (i.e. its primary fiscal deficit). Nor does it provide assurance in the long run, as the fundamental weakness of state in relation to society make it difficult to exclude recurrent crises or their endemic equivalent of chronic fiscal constraint, even if Greece continues to grow moderately.

Greece, like every country before it that has been in such a situation, has no alternative but to reform the relation between state and society, regardless of what desirable reforms may take place to the international economic system. A functioning state must be capable of taxing and must be capable of saying no. It must make sound investments and must productively organize economic life. However, none of this suffices for political institutions to be *well* functioning. Throughout the world there is a choice between a more democratic and socially inclusive route to the emergence of a capable state (which in turn serves the ends of democracy and social inclusion) and a more authoritarian and non-inclusive route (which serves the few). Only one of these roads is desirable. Finding it is the work of politics.