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Flashing Red: European Debt Crisis Signals Collapse of Social Welfare State

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Europe's socialist (or "social democratic") welfare state is collapsing under the load of unsustainable debt. There is no chance European politicians will ever make good on the many costly and unfunded entitlements they have promised their citizens.

The fundamental problem in the European Union is a monetary policy failure. In conjunction with the debilitating effects of the social welfare state, this has led to a broad economic collapse among the lesser states—notably the PIIGS (Portugal, Ireland, Italy, Greece, and Spain), but also some of the EU's newer members—and it threatens to envelop the greater states.

For years, this collapse among the lesser states was disguised by debt accumulation—countries would borrow (at de facto concessionary interest rates) to overcome their inability to generate adequate income by producing and selling. The lack of actual and prospective growth combined with growing debt burdens has led to a long-term solvency crisis, which has been bubbling up of late into a series of liquidity crises.

The monetary and fiscal situation in the EU is increasingly unmanageable, as the debt burdens grow and growth prospects diminish further. To paraphrase an old saying: You can fool some of the credit markets all the time, and all the markets some of the time, but you cannot fool all the credit markets indefinitely.

The Ill-fated Euro Experiment. The vision of a "euro zone" was ill-conceived from the start. It is now increasingly acknowledged that Brussels' lack of control over social spending, especially in the PIIGS, doomed it from the beginning. Agreements (e.g., the Maastricht Treaty)[1] to stay within EU member government spending targets were routinely flouted, even by the largest EU countries.

But the growing gap in competitiveness amongst EU members was far more important. Some, like Germany, tended to adopt policies like labor market reforms that built on their inherent economic strengths. The strong got stronger, while others, like Italy and Greece, stood still or even retreated on policies that would have sustained their international competitiveness. The focus today on shifting painfully to policies that can make these countries competitive is simply too little, too late.

And now, the instability is rapidly spreading to the pillars of Europe—first Spain, then Italy, and now apparently to France. Southern Europeans kept borrowing in low-interest-rate euros (which simultaneously inflated housing bubbles in their countries) until, in Margaret Thatcher's words, their socialist governments "ran out of other peoples' money!"[2] As a result, some of Europe's large private banks now hold toxic quantities of sovereign

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debt issued by the PIIGS and are threatened with extinction through serial defaults—thus they are deemed "too big to fail." Already there is growing worry over the solvency of France's Societe General Bank because of this crisis, with several other major European banks likely to be in trouble if the situation is not resolved.

Social Results of the Welfare State. For decades now, one of the most tragic costs of the European welfare state has been Europe's structural unemployment, especially among the young, combined with welfare payments that turned unemployment into an acceptable—even desirable—status, while stripping those affected of their dignity and sense of responsibility. The recent riots in the U.K. are an ominous reflection of this failure.

One of the key questions now is: How much longer will workers and taxpayers in Germany and other relatively more fiscally prudent countries in northern Europe be willing to work into their late 60s to subsidize (via eurozone bailouts and managed defaults) their neighbors in southern Europe so that the latter can retire early in their 50s on generous state-funded pensions and go to the beach?[3]

The Next Monetary Policy. The euro elites' response to date has been to try to address the solvency crisis through fiscal policy, and the liquidity crisis through additional debt—ignoring the EU's monetary policy failure because they have no politically acceptable solution. It is obvious where this will lead, as Heritage Foundation analysis has noted in the past.[4]

Maybe, instead, some of the PIIGS will decide to exit the euro. Or perhaps the northerners will leave the euro (and the euro-denominated sovereign debts of the PIIGS) behind and resuscitate the Deutschmark? One path or the other appears inevitable.

The European social welfare state has contributed mightily to this situation by making all of Europe less competitive relative to the rest of the world, which is why the U.K., though not subject to the monetary policy failure, cannot escape the growth consequences entirely. Meanwhile, Germany's inherent strengths have allowed it to take advantage of its Euro-linked trading partners.

Lest there be any doubt, the underlying monetary policy failure is the euro. It is now quite clear that this policy was doomed, not solely because Europe failed to harmonize it with other policies, but because monetary union between fast-growth states and slow-growth states can only end in tragic monetary disintegration. The hope that it would cause slow-growth states to catch up was a pipe dream.

Will Europe's elites succeed in making one more try to save the eurozone, perhaps by creating a central EU treasury that alone has the power to issue new debt for EU countries? This would guarantee that the PIIGS pay lower interest rates than their credit histories would mandate, while the north pays more.

French President Nicolas Sarkozy reportedly aims "to seize the Greek crisis to make a quantum leap in eurozone governance."[5] The recent assertion by Berlin and Paris that a new eurobond is dead on arrival,[6] however, suggests Germany's patience has just about run out—apparently, that quantum leap will have to be in a different direction.

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3. Bernd Radowitz, "Pressure Mounting on Merkel," *The Wall Street Journal*, August 10, 2011, at *http://online.wsj.com/article/SB10001424053111903918104576500073224481798.html?mod=googlenews_wsj* (August 15, 2011).
4. Robin Harris, "Europe: What Future?" Heritage Foundation *Special Report* No. 81, July 15, 2010, at *http://www.heritage.org/Research/Reports/2010/07/Europe-What-Future*.
5. Tony Barber, "Has Europe Been Rescued?" *Financial Times*, July 22, 2011, at *http://www.ft.com/intl/cms/s/0/8b1caeee-b48d-11e0-a21d-00144feabdc0.html#axzz1V7ZEHQ5K* (August 15, 2011).

For the U.S., Europe is the ultimate object lesson—a warning of what happens when government is allowed to run wild, with the resulting loss of liberty and fiscal deficits. Fortunately, though the United States has a single currency, it largely achieved the necessary conditions for such an arrangement to be successful long ago.

Rescuing Europe and Protecting the U.S. It is almost certain that this crisis will produce something new out of Europe. The emergence, whether collectively or individually, of stronger European societies with durable financial and monetary regimes would certainly be in the best interest of the U.S. and the rest of the world.

As Ambrose Evans-Pritchard reports in *The Telegraph* (U.K.),[7] the likely short-term outcome is described by Daniel Gross from the Centre for European Policy Studies: "Germany and the other AAA states must agree to some sort of Eurobond regime. Otherwise the euro will implode." However, as noted above, France, and especially Germany, have been stoutly opposed to a eurobond, and for very good reasons. Assuming Gross is correct in his assessment, and he most likely is, the future of the euro is bleak indeed.

Meanwhile, spending by the U.S. government—presently on track to consume one-third of the economy by the time today's newborns graduate from college—must be reduced. Entitlements must be reined in and reformed; non-defense discretionary spending must be rolled back to 2008 levels.

To reduce federal spending and prevent economic collapse, U.S. policymakers should follow The Heritage Foundation's plan in "Saving the American Dream."[8]

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6. Peggy Hollinger, Chris Bryant, and Quentin Peel, "Germany and France Rule out Eurobonds," *Financial Times*, August 14, 2011, at *http://www.ft.com/intl/cms/s/0/d4ddaa06-c68f-11e0-bb50-00144feabdc0.html#axzz1V7ZEHQ5K* (August 15, 2011).
7. Ambrose Evans-Pritchard, "ECB is Euroland's Last Hope as Bail-Out Machinery Fails to Resolve Crisis," *The Telegraph*, August 14, 2011, at *http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/8700782/ECB-is-eurolands-last-hope-as-bail-out-machinery-fails-to-resolve-crisis.html* (August 15, 2011).
8. Stuart Butler, Alison Acosta Fraser, and William Beach, "Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity," Heritage Foundation *Special Report* No. 91, May 10, 2011, at *http://savingthedream.org/about-the-plan/plan-details/SavAmerDream.pdf*.