Greek Govt Attempts to Solve Financial Crisis by Crackdown on Tax Evaders

The four European Union members known together as PIGS (Portugal, Ireland, Greece, and Spain) are those countries whose general irresponsibility and massive government overspending has been enough to drive down the value of the euro as the interest rates on their government bonds are pushed to unsustainable levels. Last year the financial collapses in these countries, especially Greece, caused the euro to plummet 15 percent in just the first six months of the year.

The fiscal crisis in Greece is profound. One year ago, it was granted a loan package from the EU and the International Monetary Fund of €110 billion — a figure now known to be a sizable underestimation of just how much the Greek government had overspent in 2010. The government deficit for last year had originally been estimated at 9.6 percent of the nation's GDP, but was revised to 10.5 percent. The 2009 deficit had been 15.4 percent of GDP and the Greek government had promised to reduce this to 8.1 percent for 2010.

This sort of underestimation of the problem is all too familiar with these PIGS: the projections are nearly always much more optimistic than the truth. There is also grim news from Portugal: Over the weekend, Eurostat (the Directorate-General of the European Commission which provides the EU with statistical information concerning the member states) reported that the Portuguese GDP-to-deficit ratio for 2010 has been revised upward from 7.3 percent of GDP to 9.1 percent. Spain's financial situation is also critical. In a recent auction of Spanish bonds the yield on six-month bonds was 1.8 points higher than at the auction last month. Rabobank rate analyst Richard McGuire observed: "There is little scope for further such increases in short-dated funding costs before the market begins to get spooked over Spanish contagion." And confidence is waning not just in the ability of Spain to pay its debts, but also in that of Ireland, Iceland, and perhaps also Belgium, which has still not formed a government more than a year after the general election.

Greek Finance Minister George Papaconstantinou explained that the latest bad news was "Mainly the result of the deeper than anticipated recession of the Greek economy that affected tax revenues and social security contributions." What can the Greek government do about this? More government borrowing will be increasingly expensive. The yield on 10-year government bonds has risen to a dizzying 15.5 percent. Investors have simply lost all faith in the ability of the Greek government to meet its obligations.

IHB Global Insight analyst Diego Iscaro noted: “The revision shows how difficult the government’s job is of sticking to its fiscal promises against a backdrop of an extremely weak economy. The figures will do nothing to end the constant rumors of debt restructuring we’ve had in recent weeks.” The loss of confidence in the ability to the Greek government to handle the crisis is compounding the problem. Greece has promised to raise an additional €11.8 billion in revenue this year and in 2012. A major part of that increased revenue is supposed to come from a crackdown on tax evasion.

For problems such as those facing Greece (and the three other PIGS nations), there are several solutions: (1) reduce expenditures so the debt can be paid; (2) borrow money to pay for the deficit; (3) increase revenues by raising tax rates; (4) increase revenue by stimulating private growth through lower tax rates and less regulation; and (5) increase revenue through “crackdowns” on tax evasion.

But analysts are concerned over Greece’s ability to reduce its expenditures significantly. Greek unions, both public and private, have recently gone on strike to protest the spending reductions already made by the government in response to the financial crisis. Prime Minister George Papandreou has told the unions that there is no magic recipe for addressing the debt crisis and that austerity measures are unavoidable. The problem is that unions, particularly of the public-employee type, have been pandered to for so long in Greece that it is problematic that any politicians will have the backbone to make the necessary cuts in spending to bring public debt to manageable levels. Greek unions are planning massive nationwide strikes on May 11 — timed to coincide with visits by IMF and EU inspectors — intended to bring the government to its knees. Such strikes will naturally reduce economic productivity and thereby revenues, considerably worsening an already critical situaton. The strikes wil also convince the IMF and the EU that Greek workers have no intention of making any real sacrifices to restore the confidence of investors.

Until recently, the Greek government has avoided cuts in spending (which would mean reductions in the compensation and benefits of government workers) by relying on borrowing, one of the other ways of handling deficits. But the sky-high interest rates that Greece must pay on its bonds, coupled with the almost total lack of investor confidence in these bonds, makes this approach untenable. The increasingly high interest rates become a future and unavoidable public expenditure.

Greece could also raise tax rates. That, up to a certain level of taxation, can raise government revenue. However, raising the already high levels of taxes could easily depress economic activity enough that the result would actually be lower revenue. Such is the long-term effect of hiking tax rates: businesses and productive people tend to leave places with higher taxes for places with lower taxes. Thus, as the tax base shrinks, so does revenue. People either work less, or hide what they earn, or move away; they do not work harder just so politicians can stay in office. As tax revenues in Greece are already equal to 40% of the nation’s GDP, it is obvious that low tax rates are not the reason for the country’s financial crisis.

One other solution for Greece would be to reduce government regulation, lowering tax rates to attract business, privatizing government-run industries, and thus rewarding innovation and productivity. A substantial increase in economic activity by the private sector could create a larger tax base with somewhat smaller tax rates. No one, however, seems to be considering such a common-sense approach.

So Greece, at the urging of the European Union, is looking at a “crackdown” on tax evaders. Such an action is politically safe, as it does not involve raising tax rates and it collects revenue only from those who have been avoiding taxes illegally. In practice, however, this sort of intensified tax compliance is like a tax hike, and the more draconian the enforcement of tax laws is, the less likely businessmen are to work hard or to even stay in Greece.

Greece's options are few and shrinking rapidly. Its politicians have as yet not shown the will to provide realistic solutions and to make the hard, unpopular choices.

Photo: Greek Finance Minister George Papaconstantinou speaks during a news conference in Athens on Feb. 24 , 2011: AP Images