Introduction
Europe's Crisis and the Welfare State
Michael Tanner

Margaret Thatcher once quipped about the problem facing modern social welfare states: "They always run out of other people's money." Today, in country after country, we are seeing that prophetic remark coming true. The headlines have been dominated by the problems of the so-called PIIGS (Portugal, Ireland, Italy, Greece, and Spain), which face the most immediate economic crisis and have required economic support from the International Monetary Fund and other European countries. However, even countries with relatively robust economies, such as France and Germany, are facing unprecedented levels of debt.

Unless the countries of Europe reform their welfare states, they will face some combination of huge tax increases or default on their obligations, both explicit and implicit. The result will be social upheaval and continued economic stagnation. The tough choices facing those countries are playing out today in parliaments and on the streets. The future remains highly uncertain.

But how much better off is the United States? Our national debt exceeds $16.4 trillion and is increasing at a rate of more than $3 million per minute. And that only represents the debt that is actually "on the books." If the unfunded liabilities of Medicare and Social Security are included, then U.S. total indebtedness could top 800 percent of GDP.

The Fall of the Welfare State

The reason for this dire fiscal situation is the massive expansion of the welfare state that has taken place in the years following

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World War II, first in Europe but more recently in the United States. As government has taken responsibility for more and more areas of our lives—from retirement and health care to protecting us from unemployment or guaranteeing a minimum level of income—it has grown ever bigger, more costly, and more intrusive. At the most basic level, it has become unaffordable.

Despite an ever growing tax burden, it has become impossible to pay for all the demands of the modern welfare state. At the same time, simply attempting to pay for those demands has slowed economic growth and left citizens poorer. A vicious circle was created, leaving countries unprepared to react to the onset of financial crisis and the worldwide recession that followed. The result has been a painfully slow and anemic recovery.

The future of the welfare state is now open to question. Some argue that the financial insecurity illustrated by the banking collapse and recession demonstrate the need for a social safety net. Others tout the stimulative effect of government spending and warn that whatever long-term debt burdens countries may face, austerity in the short term would undermine recovery. Still others warn that only a fundamental restructuring and downsizing of the welfare state can restore a foundation for economic growth and prosperity.

With federal spending, debt, and deficits all at or near record levels, and entitlement programs such as Medicare, Medicaid, and Social Security facing enormous future shortfalls, this debate is particularly crucial to the United States. The lessons that America learns from Europe's crisis will go a long way toward determining future U.S. economic growth and prosperity.

Fundamental Questions

This special issue of the *Cato Journal* features articles from academics, economists, and politicians representing both Europe and the United States examining the crisis in Europe and the lessons that the United States can and should learn from Europe's problems. The authors attempt to answer such fundamental questions as:

- What brought about the economic crisis confronting Europe?
- What is the best way to analyze the underlying problems confronting European economies?
- Has the modern welfare state become unaffordable?

- How can countries adapt to changing demographics and aging societies?
- What does austerity really mean and should countries pursue it?
- In dealing with the debt crisis, should countries cut spending, raise taxes, or both?
- Why have some European countries successfully restructured their welfare states while others have failed?
- Is the United States on the road to the same type of crisis as Europe?
- What reforms should the United States undertake to reduce its debt and grow its economy?

An Overview

In the opening article, Jagadeesh Gokhale and Erin Partin examine the true size of the fiscal challenge facing Europe and the United States. Both have to deal with an aging population and an intensifying competition in global labor markets. Those trends have led to increasing demands for welfare state protection—particularly retirement and health care benefits for a bulging retiree cohort and income support for low-skilled workers. Gokhale and Partin warn that unless growth of welfare programs is curbed, and health care costs checked, higher fiscal burdens on today's young workers and future generations—and a spending squeeze on other government operations—appear inevitable.

In the second article, I compare the United States' debt problem to those of Europe and ask whether we are on the road to a similar crisis. My research suggests that our fiscal problems are much larger than commonly believed and of a similar order of magnitude of those of Europe. It is only the size of the U.S. economy and the dollar's status as the world's reserve currency that has staved off a major crisis. But without reform, that situation cannot continue indefinitely.

The next two articles look more deeply into the U.S. debt problem. Pierre Lemieux argues that, contrary to popular belief, the American and European welfare states differ only in degree, not in type. As the American economy becomes Europeanized, there will be slower growth combined with higher spending and a more developed welfare state. As a result, the United States should anticipate a debt crisis similar to that of Europe. Desmond Lachman also

concludes that there are far more similarities than differences in the U.S. and European welfare states. He points out that, while the crisis in Europe has contributed to low U.S. interest rates, America should not be lulled into a false sense of security, and should instead enact a serious deficit reduction program.

The articles by Veronique de Rugy and Pascal Salin provide different takes on the question of whether countries should respond to the debt crisis with austerity. De Rugy points out that despite the attention paid to European "austerity," few European countries have truly reduced spending, or reformed the structural problems of their welfare states. Much of what is labeled austerity has actually been tax hikes, which slowed economic growth and made the problem worse. Salin argues that much of the debate over European reaction to the crisis has been stuck between two false models: Keynesian stimulus or austerity. Because countries in Europe have relied on monetization of debt, increased expenditures, and a lack of tax cuts, they are in danger of falling into long-run stagnation. A better approach, he suggests, would be a policy mix composed of real cuts to public expenditures, welfare payments, and tax rates. Salin suggests that this would help solve the long-run "eurosclerosis" problem and boost economic growth.

The final three articles examine how three different European countries have dealt with the crisis—for better or worse. Mark Hallerberg says that welfare reforms in Germany in the early 2000s, along with restructuring in the private sector, helped Germany turn its economic performance around and emerge as one of the best performers in Europe during the Great Recession. Still, Hallerberg warns, future demographic changes in Germany mean that the welfare state in its current form is not sustainable. Estonian Finance Minister Juhan Parts recounts the experience of his country, where a conservative fiscal policy, real spending cuts, and a history of prudent fiscal management in the years before the crisis were key to his country's strong recovery from the recession and financial crisis. Parts stresses the importance of political leadership in restructuring the welfare state. Finally, Pedro Schwartz uses the case of Spain to provide a case study in how the burden of the welfare state made Spain's economic crisis inevitable. He concludes that unless Spain (and other countries) confront the fundamental need to reduce the size of the welfare state, they will be unable to generate the economic growth necessary to recover from the recession.

European welfare states have slowly and tentatively begun taking steps to cut back the entitlements that are strangling their economies. But they may well be doing too little, too late. Time also may be running out for the United States to act. As Alan Greenspan (2010) warned in his typically understated way, "The very severity of the pending crisis and growing analogies to Greece set the stage for a serious response. . . . Our economy cannot afford a major mistake in underestimating the corrosive momentum of this fiscal crisis. Our policy focus must therefore err significantly on the side of restraint."

This special issue of the *Cato Journal* should enhance public understanding of the negative consequences of expanding the welfare state on economic growth in Europe and the United States, and reinforce the fact that only fundamental reform can prevent further declines.

Reference

Greenspan, A. (2010) "U.S. Debt and the Greece Analogy." *Wall Street Journal* (18 June). Available at http://professional.wsj.com/article/SB10001424052748704198004575310962247772540.html?mg=reno64-wsj.