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Debt Crisis in Southern European Welfare Regime

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Abstract
The financial crisis, which emerged in the USA in 2008 and continued to spread all over the world, was followed by the European debt crisis near the end of 2009. The factors leading to the debt crisis can be divided into two main categories: Firstly, the countries fell into the crises as a result of the gradually growing burden of debt (Greece, Italy, Spain, and Portugal) was also the countries which have "Southern European Welfare Regime". Public and social expenditures in these countries are lower than those countries with a higher national income per capita. However, these countries have considerably exceeded their potential of public and social expenditure. On the other hand; these countries, with their lower levels of productivity, have become even less efficient by the effect of Euro and, because they had easy access to loan, were able to significantly increase their burden of debt. As a result, Spain and Portugal faced a liquidity crisis, while Greece and Italy faced a default crisis. This study handles the welfare regimes in these countries within the framework of the current debt crises they experience, given that a profligate welfare regime has a direct or indirect role in a crisis. For this purpose, the social expenditure increase in Southern European Welfare Regime countries is analyzed and correlated with their current debt crisis.

Key Words
Debt Crisis, Economic Crises, Social Expenditure, Southern European Welfare Regime, Welfare Regimes.

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The most distinct common characteristic of the Southern European countries affected by the 2008 economic crisis emerging in the USA was the fact that they all fell into the *Southern European Welfare Regime* paradigm. Though these countries' rate of public and social expenditures to gross national product (GDP) was not higher than those countries with higher per capita income, these specific countries expenditures were above their potential thereby causing serious deficits in their budgets.

The basic causes of the debt crisis, which emerged in Europe and which mostly affected the Southern European Welfare Regime countries, included monetary union problems, loose fiscal discipline, insufficient audits, economic actors' excessive borrowing by taking too much risk, vulnerabilities in banking systems, problems in the residential sector, inadequate economic growth, high figures of unemployment, residual economic disequilibria, lack of compatibility, and management problems in the Euro region (Kibritçioğlu, 2011; Nelson, Belkin, Mix, & Weiss, 2012; Yang & Lei, 2012).

In addition to these basic causes, some authors also note that social welfare expenditures of Southern European Welfare Regime countries were too high and that these countries acted fiscally irresponsible (Lemieux, 2013; Tanner, 2013; Yang & Lei, 2012). Krugman (2012a), however, argues that the debt crises was caused neither by the level of social welfare expenditures setting a premium on individuals living in poverty nor by fiscal irresponsibility.

There are various surveys that attempt to explain the relation between Southern European Welfare Regime countries' debt crisis and their social welfare policies. The surveys conducted by Matsaganis about Greece (2011), Schwartz about Spain (2013), Cencig about Italy (2012), and Glatzer about Portugal (2012) all show the relation between the debt crises faced by these countries and their welfare state practices and social expenditures.

On the other hand, public expenditures of Southern European Welfare Regime countries remain less than the public expenditures of Corporatist/conservative and of Social Democrat Welfare Regime countries, but are higher than of Liberal Welfare Regime countries (OECD, 2009). In fact, though high rates in public

expenditures of Southern European Welfare Regime countries' do not pose any apparent problem, they do not appear to be economically reliable since public revenues are low (OECD, 2013).

The "patrimonial" perception of the state in Southern European Welfare Regime countries has caused the emergence of a clientalist[1] welfare state (Ferrera, 1996). The existence of a clientalist welfare state, exhausting public funding sources and spreading the black economy (Gough, 2008, pp. 232-233), causes great stress in social policy (Kesgin, 2013, p. 97) and acts to indirectly increase levels of social expenditures.

In this study we begin with the general characteristics of the Southern European Welfare Regime, reviewing the transformation experienced by these countries. We then handle the debt crisis suffered by these countries within the framework of the Southern European Welfare Regime, analyzing their debt crisis through the changes made in their social expenditures. Finally, we discuss how these countries can get out of the debt crisis through fiscal responsibility and amendments in the employment market.

Southern European Welfare Regime

Esping-Andersen, in the article entitled *The Three Worlds of Welfare Capitalism*, classified the welfare regimes into three: (1) Liberal, (2) Corporatist/conservative, and (3) Social Democrat Welfare Regimes (Esping-Andersen, 1990, p. 3). This particular article of Esping-Andersen received large attention in the academic community and became the most discussed and cited article in the field of welfare stare (Leibfried & Mau, 2008, p. xx). After Esping-Andersen, welfare regime modeling studies became common[2] (Abrahamson, 1999, p. 400; Arts & Gelissen, 2002, pp. 151-153).

In this classification, Esping-Andersen included only Italy among the Mediterranean countries, describing it as a Conservative Welfare Regime

1 Clientalism means, in short, the relation between the dependent and its patron (client-patronage) and refers to acts of politicians that provide privileged service to the supporting voters.

2 Abrahamson (1999) calls the welfare regime modeling trend as welfare modeling business.

(Esping-Andersen, 1990, p. 74). Although Esping-Andersen's classification was pioneering in this field, following studies raised many critics claiming the classification to be deficient and suggesting many different classifications (Arts & Gelissen, 2002; Bonoli, 1997; Korpi & Palme, 1998; Navarro & Shi, 2001).[3]

One of the first alternative classifications belongs to Stephan Leibfried. According to Leibfried (1992) Southern European countries constitute a separate welfare state regime under the name of the *Latin Rim* including Spain, Portugal, Greece and, to a certain extent, Italy, and France. Like Leibfried, Ferrera (1996, p. 20) argued that Southern European countries had a separate welfare regime and called it the Southern Model.

These countries' labor markets are radically different from the Continental Welfare Regime in that they have a strong agricultural tendency. Unlike the Scandinavian countries, these countries do not have a tradition of full employment (Kesgin, 2013, p. 97). While Southern European countries try to parallel their Northern neighbors in welfare state practices, unlike the Northern states, family and church continue to serve a great social aid function in Southern European countries (Pierson, 1998, p. 780). Though the constitutions of these countries make strong emphases on a modern welfare state, practices necessary to fulfill such a model are not often implemented. This fact has earned the Southern European welfare states the title of "Regimes of Institutionalized Promises" (Leibfried, 1992).

The income substitution system in these countries is seriously fragmented and distorted, leading to a significant level of polarization. For instance, according to Ferrera, although the social benefits these countries offer are generous (in other words, somewhat profligate) to the "basic sectors" of the labor force located in the institutional labor market, social benefits provided to those located in the non-institutional labor market which constitutes a rather large part of the occupational sector are fairly timid. However, these countries deviate from the conservative tradition in healthcare services and have created a somewhat universal healthcare insurance system (Ferrera, 1996, p. 19).

3 The beginning of classification efforts for welfare states can be dated back to Wilensky and Lebaux (1958). In their article, Wilensky and Lebaux made a distinction in the concepts of welfare, where they mentioned the concepts of the residual and corporatist welfare state. Titmuss (1974), studying the same subject, classified welfare states into three: Residual Welfare Model, the Industrial Achievement Model, and the Corporatist Redistributive Model.

Kautto (2002, p. 53) tries to classify the welfare states according to their approach of service and transfer.[4] The third group in Kautto's classification is the low approach. Both transfer and service expenditures are low in Ireland, Greece, Portugal, and Spain, all of which constitute the countries in this group (Kautto, 2002, p. 62). Kautto claims that both transfer and service expenditures are law in Southern European welfare regimes, with the sole exception of Italy.

Social Expenditures in Southern European Welfare Regimes

Greece, Spain, Italy, and Portugal did not have, in general terms, a higher level of social expenditures before 1980 than did other welfare regime countries. Furthermore, although the average level of expenditures by Southern European Welfare Regime countries is lower than the average of Social Democrat and Conservative Welfare Regime countries, it is higher than the average expenditure level of Liberal Welfare Regime countries (OECD, 2012).

On the other hand, the welfare regime in Southern European Welfare Regime countries has experienced a significant transformation with the advent of the1980s. Beginning with the 1980s, the ratio of social expenditures to GDP boomed in these countries, making up most of the gap regarding social expenditure levels between them and other welfare regimes. Though other welfare regime countries have increased their level of social expenditures during the same period, such increase was far more behind that of Southern European Welfare Regime countries. As such, Southern European countries, leaving Liberal Regime countries behind during the 1980's, reached roughly the same level of social expenditures as both Social Democrat and Conservative Welfare Regime countries (OECD, 2012).

4 Service approach countries are Sweden, Denmark, Norway, Finland, France, and, more recently, Germany and the United Kingdom. Transfer approach countries have a higher level of transfer or a lower level of service expenditures. This group includes Belgium, Netherlands, Austria, and Italy.

Indebtedness in Southern European Welfare Regimes

In terms of indebtedness in Southern European Welfare Regime countries, Greece and Italy, on one side, and Spain and Portugal, on the other, share apparent similarities. The levels of public indebtedness in Spain and Portugal are very high when compared to those of Continental countries. Portugal's level of public indebtedness was approximately 60% before the onset of the 2008 financial crisis, increasing to 80% in the wake of the crisis. Spain's general level of indebtedness had been in a better condition than that of Portugal; Spain's public indebtedness level was roughly 30% before the crisis, increasing to 50% after its onset (OECD, 2011). As seen, Spain's and Portugal's levels of indebtedness are not too high; instead, these countries mainly suffer from a *liquidity crisis*.

Greece and Italy, face a completely different set of experiences. These two countries' indebtedness ratio had been quite high before the onset of the crisis. Italy's level of indebtedness was roughly 90% in the 2000's, while Greece's level of indebtedness was nearly 100%. After the crisis however, both countries' level of indebtedness grew even more, reaching around 100% in Italy and 140% in Greece in 2010. As seen, these two Southern European Welfare Regime countries are facing a *default crisis* due to their high levels of indebtedness (OECD, 2011).

Debt Crisis in Southern European Welfare Regime Countries

There is no doubt that the high levels of indebtedness and lenders' significant distortion in perceiving the risks of these countries after the crisis are the underlying factors of the deep crisis faced by Southern European Welfare Regime countries. Greece and Italy, especially, carry burdens of debt much higher than the other European countries, and although the burden of debt of Portugal and Spain are relatively reasonable, there are serious concerns on their ability to be able to cover their debts since both countries' labor

efficiency[5] levels (World Economic Forum, 2012, p. 13) and GDP growth rate are quite low[6] (World Bank, 2013).

As such, welfare state practices must be addressed in order to understand the background of the crisis. Within the framework of the modern era[7], welfare state practices lived their golden age with the help of the rise of the Keynesian economics[8] in the period between 1950s and 1970s in numerous developed countries.

The period between 1960 and 1975 Continental countries increased their social expenditures to GDP ratio dramatically and their GDP growth rate also doubled (George, 1996).[9] On the other hand, social expenditures to GDP ratio of the Southern European countries increased timidly, although their welfare regime had been already weak. It had hardly reached 8.6% and 11.8% in Greece and Spain, respectively. In Italy, the same rate was 13.1% in 1960, reaching 21% by 1975 (George, 1996).

On the other hand, political experiences of Southern European countries during the same period were also different than those of the Continental countries. Lagging far behind the Continental countries in terms of industrialization and economic growth, these countries were also politically severed from the Continental countries after World War II. Greece, Spain, and Portugal were ruled by non-democratic governments until the 1970's (Bermeo, 1987; Danapoulos,

5 Spain ranks 36th and Portugal ranks 49th in the Global Competition Report of 2012-2013. According to the same report, Italy ranks 42nd and Greece ranks 96th. These Southern European Welfare Regime countries are considered weak in competition because of their macro-economic disequilibrium, inadequacy in having fiscal access, solid labor markets, and deficiency of renovative practices.

6 Portugal grew by -1.6% and -3.2% percent, while Spain grew by 0.4% and -1.6% percent in 2011 and 2012, respectively. As the other representatives of Southern European Welfare Regime, Greece grew by -7.1% and -6.4% percent, while Italy grew by 0.4% and -2.4% in the same period. Taking the year 2012 as the basis, we see that growth in Mediterranean countries has been negative, leading to an economical downsize. During the same periods however, the USA grew by 1.8% and 2.2% percent, the UK grew by 1.0% and 0.3% percent, Germany grew by 3.0% and 0.7% percent, and Austria grew by 2.7% and 0.8% percent in 2011 and 2012, respectively.

7 Before the modern age, there are lots of practices which can be thought as welfare state practices. For instance, as early as the 7th century, the address of the first Arabia caliph Ebu Bekir to Hire public sheds very interesting light with regard to welfare state: "The needy people who got old or ailing or disabled and have lost the ability to work will be put on a salary by Treasury" (Yeniçeri, 2009, p. 49). These kinds of welfare state practices carried on in the period of the other Arabia caliphs. For instance, Caliph Ömer put poor, blind and leper people on a salary in the very same century.

8 "These were years when the influence of the ideas Keynes advanced began to shape hearts and minds everywhere" (Townsend, 2002, p. 3).

9 The IMF, the World Bank and GATT, as then newly founded institutions, made fundamental contributions to the newly arising world economic order. However, there are also arguments that organizations such as the IMF and the World Bank have negatively affected welfare state practices. For example, Özşuca (2003) argues that income distribution is distorted in countries that apply stability and structural compliance programs offered by international organizations such as the IMF and the World Bank.

1983; Moreno, 1997). Italy, however, was ruled by a fascist regime headed by Mussolini from 1922 until 1946; after which it switched to democracy (Rus, 2012).

There are important similarities between Spain and Portugal. These two countries share a common historical tradition and strong Catholic sense whereas Greece follows an Orthodox Christian tradition. These three countries were ruled by a monarchy and, as mentioned before, left far behind by Continental countries in terms of industrialization (Guillen, Alvarez, & De Silva, 2002, p. 2).

Having escaped dictatorship and switching to democracy about in the middle of the 1970's, Greece, Spain, and Portugal entered the European Community in the 1980's. During the process of admission to the European Community, these countries tried to follow the lead of the Continental European countries in terms of welfare state practices in an effort to strengthen their welfare regimes, which had been quite weak until then.[10]

Southern European countries, having had very weak welfare regime in the 1970's, made significant progress in their social policies in the 1980's. By 1980, social expenditures to GDP ratio was 13.42% on average in Southern European Welfare Regime countries., This average was much lower than the average rates of Social Democrat (21.71%) and conservative welfare (21.23%) regimes. By 2007 however, Southern European countries reached to the point of catching up with the Social Democrat and Conservative Welfare Regime countries and left behind Liberal welfare regime countries in terms of the social expenditures to GDP ratio. The average social expenditure to GDP ratio reached 24.78% for Social Democrat Welfare Regime countries, 24.15% for conservative welfare regime countries, 17.39% for Liberal welfare regime countries, and 22.57% for Southern European Welfare Regime countries (OECD, 2012).

By 1995, the expenditures to public expenditures ratio in Liberal, Social Democrat, and Conservative Welfare Regime countries were 42.45%, 48.45%, and 48.45%, respectively, while it was 40.90% on average in Southern European Welfare Regime countries. By 2007, the social expenditures to public

10 There are arguments (dependency theory) claiming that Western prosperity causes a kind of "addiction." According to the dependency theory, economic growth in industrialized countries is provided by the added value obtained from underdeveloped countries (Smith, 1979).

expenditures ratio in Liberal, Social Democrat, and Conservative Welfare Regime countries were 42.29%, 51.98%, and 53.75%, respectively, while it was 51.02% on average in Southern European Welfare Regime countries. Therefore, in a 12 year period, the rate of social expenditures to public expenditures increased in Liberal, Social Democrat, and Conservative Welfare Regime countries by 6%, 5%, and 8%, respectively, while it increased an average of 20% in Southern European Welfare Regime countries (OECD, 2012).

On the other hand, though Southern European countries welfare regime caught up with the other welfare regimes in terms of social expenditures levels, their welfare regime has yet to be developed with regard to the quality of the social service they provide. The fact that these countries have a clientalist nature has a significant impact on this reality. In addition, sparing an important portion of the social expenditures for retirement benefits, as in Greece, renders the system irregular which has negative impacts on welfare regime (Mylonas & Maisonneuve, 1999).

At this point, the nature of the social expenditures must be addressed. As known, money is a luxury good according to Milton Friedman who argues that the amount of money kept by people increases more than the rise in their wealth level.[11] In this context, we will consider the social benefits provided by the state as a *luxury good*. The essential basis for claiming social benefits are luxury goods is the fact that these benefits are directly dependent on a personal level of wealth/income and are therefore part of tax revenues. This is because social expenditures represent a transfer from holders of wealth/income to people without wealth/income in general terms, especially when the actuarial balance is omitted. Notably, the fact that retirement benefits hold a significant portion in social expenditures makes the situation more clear.

Since social benefits are considered to be a luxury good, it is harder for relatively poor countries to collect more taxes from their citizens in order to achieve a higher level of social expenditure than for relatively rich countries. In that sense, we suggest that the marginal sacrifice emanating from extra collected taxes in the same level from people of relatively poor countries is higher than that of relatively rich countries. So in relatively poor countries the ratio of social expenditure to

11 Therefore, the income elasticity of money is greater than one. Similarly, according to Keynes, people's level of savings increase as their level of wealth increases.

GDP should be lower than that of relatively rich countries once balanced budget of government is required.

In a period when globalization continues to rise at a considerable level, bringing with it pressure on tax rates, it becomes even more difficult for Southern European countries to develop their social states.[12]

Among the OECD countries, except the *liberal* welfare regime countries which pursue neo-liberal policy, generally and roughly; the richer the country the more tax burden (tax revenues to GDP ratio) the country has. Yet, except Canada and Ireland, in the countries which have a GDP per capita below a certain level (33.000 dollar), after experiencing above 35% ratio of tax burden in the 1990s, the tax burden to GDP ratio started to decline and leveled around 30% in the 2000s. On the other hand, GDP per capita in Greece and Portugal is around 25.000 dollars and in Spain and Italy around 32.000 dollars as of 2011 (OECD, 2012).

These findings we have acquired support our suggestions that relatively poor countries should face more obstacles than relatively rich countries face with regard to collecting tax and that there is a natural pressure on tax burden after a certain ratio.

In this respect, the booming social expenditure to GDP ratios in Southern European countries which almost leveled with that of the other welfare regimes countries from 1980s through 2000s, should be provided by assuming more debt, in light of that their inability to increase their tax revenues enough to finance booming social expenditures.

The data confirms this suggestion. The public debt burden of Southern European Welfare Regime countries has increased significantly since the 1980's in parallel with the boom in their social expenditure to GDP ratios.[13] In line with the fact that Italy's level of social expenditures, whose social expenditure to GDP ratio was more higher than other Southern European countries then, was higher than the other

12 Countries, which became open to international competition as a result of the globalization, would compete in taxation by lowering the tax rates until the deep, so efficiency and sustainability of social state in Southern European Welfare Regime countries' will be damaged by such competition.

13 Though those were the years, when financial and economic liberalization increased, such transformation had an indirect impact on the public finance.

Southern European Welfare Regime countries in the 1970's, its public debt burden started to rise in the 1970's, and continued to do so in the 1980's.

Comparing the per capita income levels to the social expenditure levels of Greece and Sweden gives the following outlook:

In 1980, the social expenditure level was 10.24%, while per capita income was 6,509 USD in Greece and public debt burden was 24.6%. In the same year in Sweden, a mature welfare regime country, however, the social expenditure level was 27.16% and per capita income was 15,739 USD, its public debt burden was 39.3%. Since then, the social expenditure level of Greece has almost doubled, reaching 20.96% and its per capita income has reached 25,562 USD. Similarly, its public debt level has increased to 111%. During the same period however, Sweden's social expenditure level and public debt burden has experienced only a very timid change whereas its per capita income has increased from 15,739 to 39,539 USD (OECD, 2012; World Bank, 2008). As seen, there is a relation between the change in public debt burden and the change in social expenditures in these two countries.

After taking into consideration these two countries' previous and current situations, a correlation is seen in the increase of social expenditures and public debt burdens of the Southern European Welfare Regime countries since the 1980's. This therefore indicates the possibility that increasing social expenditure rates were among the causes leading to the debt crisis presently faced by Southern European Welfare Regime countries.

Conclusion

The crisis currently faced by Southern European Welfare Regime countries has roots reaching far before the global economic crisis of 2008. By making social expenditures disproportionate with their wealth levels, these countries paved the way for huge increases in their public debt burdens.

In this study we tried to show that the crisis faced by Southern European Welfare Regime countries is somewhat underlined by the fact that social expenditures in these countries far exceeded their capabilities.

Since these countries are in a debt crisis, they should reduce their debt levels by decreasing social expenditures gradually. Yet they also should increase GDP growth rates in order to contract their debt burdens further.

Decreasing social expenditure level is not an easy task. It should be done gradually since sharp reductions in social expenditure level both contracts the state too fast and hurt excessively people relying on social services the state provide. Too fast a contraction of the public sector drives the country into region of even deeper crisis by making GDP growth rates even bleaker.

On the other hand, these countries should try to increase their GDP growth rates by becoming more competent. The usual way of becoming more competitive is devaluing the currency by a certain rate. But these countries share a common currency and devaluing Euro is not at their disposal. This situation leaves one way[14] to these countries to make themselves more competitive: They should try to decrease real wages.

Reducing real wages will also increase the employment rate for obvious reasons. This will have positive effects on the GDP growth and tax revenues. This also will decrease the dependency ratio and the expenditures of unemployment benefits and the like. So the strain on social expenditure level and public finance will fade out too.

14 Actually there is one more way. ECB can apply an expansionary monetary policy and create modest inflation like 4-5% in richer Continental countries like Germany. This will make Continental countries less competitive which means making Southern European countries more competitive indirectly. But Germany deeply hates the idea of inflation because of the bad memories of the hyperinflation they experienced in 1920s. ECB is highly under the influence of Germany. So this way is practically non-existent (Krugman, 2012b, p. 179).

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