

Eurozone Bailout: Taxpayer Transfer to the Wealthy?

Harald Hau

When the Greek debt deal was announced, German Chancellor Merkel highlighted the private-sector involvement. She stressed that this was the result of German intransigence. According to the spin, private creditors have to accept a 21% write-down on their claims. This amounts to a €37 billion private-sector contribution. They also provide €12.8 billion in new loans for debt buyback. This buyback, however, should not count as a private-sector contribution as it amounts to an exchange of one debt for another.

The private creditors' contribution is therefore extremely modest compared to the €109 billion in new public commitments. Especially given that private creditors had the most to lose. Given that the market discount was already 50% for Greek debt, giving up 21% could be viewed as a gain. This has to be qualified as a very bad negotiation outcome for the Eurozone taxpayer.

A closer look shows the deal is much worse for taxpayers

The new plan foresees so-called credit enhancement for the new debt, which means that the new Greek debt is mostly guaranteed by the European Financial Stability Facility (EFSF) – and thus by the taxpayers. Now, in the financial world, a guarantee is worth hard cash – it's like getting automobile insurance for free.

This is no small concession given that a successful turnaround for Greece is highly uncertain. The economy still is burdened with an excessive debt of around 132% of GDP; large structural policy reforms have not yet begun and may well fail. Most creditors can foresee this and are happy to accept the public guarantees for their debt before the next and much bigger haircut comes.

We can therefore expect that they take up the debt exchange offer "voluntarily", since it is effectively a gift to sovereign creditors and not a bailout contribution.

What about Egalité? Tax for wealth, or on wealth?

More surprising is Sarkozy's spin on these events. He interpreted the new deal as an important step towards Europe's economic governance. But before taking too much pride, Sarkozy should remember that a €200 billion subsidy to sovereign creditors is a gigantic wealth transfer from the taxpayer to essentially the richest 5% of the world. In the US, the 5% richest households control roughly 70% of all financial wealth, and this percentage is not much different in the rest of the world. Ultimate ownership of bank capital and sovereign debt is so concentrated among high-wealth individuals that we should characterise the bailout subsidy as an "impôt pour la fortune" ("a tax for wealth") – a wealth tax supporting the rich.

This should be problematic in a country like France which has been fighting bitterly over the so-called "impôt sur la fortune" (a wealth tax on the rich). This latter wealth tax amounts to a mere €4 billion annually in state revenue.

Why are the French not at the barricades over the structure of the Greek bailout?

This is a difficult question. Self-censorship by the mainstream French media might play a role, which – mostly left-leaning – does not want to provide ammunition to Eurosceptics like Marine le Pen before next year's presidential elections. But even in France it will not remain unnoticed that almost all of the public funds go to creditors and hardly benefit the ordinary Greek citizen.

Why did taxpayers get such a bad deal?

In principle, governments should have been in a very strong position. Private default can end in the liquidation of a company, but a country cannot be liquidated. This puts private creditors in a very weak position when it comes to negotiating with a government and empowers the latter. But why was this not the case in the current debt crisis?

Bankers and many journalists convey the impression that we face a choice between a full sovereign bailout and a catastrophic banking crisis.

ECB executive board member Lorenzo Bin Smaghi even suggested that any talk about private bail-ins would increase the costs for the taxpayer.

Such assertions confuse more than they clarify, because they (falsely) suggest that there was no alternative.

The banking sector is the weak spot of any restructuring plan involving sovereign default. Here, direct bank support through bank recapitalisation is a much more effective and cheaper solution than a full guarantee of sovereign debt.

The taxpayers could get bank equity in exchange for their money. If this crisis is like others, there is a chance that share values recover and taxpayers break even in the long run. The 2007-2009 crisis has shown that governments are indeed able to contain a banking crisis by resolute action like forced recapitalisation and temporary nationalisation of banks.

The better prepared we are for such an event the smaller will be the impact on the economy. Europe's governments have had plenty of time to prepare over the last year, so why was such a solution not even considered?

The reasons are political. Such a solution would have upset powerful vested banker interests, even though it would have imposed the costs on those most responsible for the massive credit misallocation.

A strong negotiating position of politicians confronts two important obstacles:

- First, the finance ministry and banking authority typically lack competence and information in order to prepare contingency plans for bank recapitalisation.

There is an acute skill shortage in the finance ministry and what talent there is meets a wall of secrecy put up by an uncooperative banking sector.

- Secondly, the strong lobbying power of the banking sector deters politicians from preparing in advance and taking risks in favour of the taxpayer.

Conflicts of interest between the politicians and the bankers are rampant.

After the disastrous risk-management performance of many bankers revealed in the 2007-2009 banking crisis, it is surprising that the same people still enjoy great influence in the policy process. The consequences are predictable.

- If you ask a frog to come up with a plan for draining a swamp, you are like to end up with a proposal for more flooding.
- Bankers were asked to come up with a plan for private-sector involvement under the leadership of Ackermann and the Institute for International Finance; what they came up with was a plan for more support.

We would never ask the tobacco industry to work out a new public health policy.

A further problem is the fragmentation of political power in Europe. This prevents the political authority from taking a strong negotiating position against the sovereign-debt creditors. In 1982, when the US faced a sovereign-debt crisis brought about by US banks' lending to Latin American nations, US finance minister Baker rejected private-sector demands that the US taxpayer bail out of creditors. While this seems similar to the position of German Chancellor Merkel, her position is much weaker.

Lastly, the ECB played a very obstructive role in preventing any effective bail-in of private creditors. This strengthened the "hostage taking" of the political authorities. At times, ECB board members gave the impression of being themselves captured by the financial elite of their home country. The ECB severely damaged its own reputation by siding so strongly with creditors and bankers rather than defending Europe's taxpayers and citizens.

And the future?

If the recent Greek bailout foreshadows the future of Eurozone "economic governance", the real question is "how much of this governance can the euro survive?"

The political economy of these European bailouts is unlikely to improve before the next sovereign-debt crisis hits. This would require that politicians take on the powerful banking lobby by forcing much higher capital standards on Europe's undercapitalised banks. There is no sign of this happening. The real peril for the euro may come from a taxpayer revolt against a financial elite that has betrayed the interests of the majority of citizens.

Harald Hau is Associate Professor of Finance, INSEAD and CEPR Research Affiliate. This article first appeared in VoxEU.org.