Why Greece Should Reject the Latest Offer From Its Creditors

Debt bondage is destroying the country — for no good reason.

Reform — Greece sorely needs it. Cash — the government is running desperately short of it. So it is time for Prime Minister Alexis Tsipras to do what's best for Greece and accept its creditors' reform demands in exchange for much-needed cash. That is how the Greek situation is usually framed. It is utterly misleading.

Imagine you're in prison for not being able to pay your debts. (You're right, it's almost unthinkable — civilized societies no longer lock up bankrupt individuals. But bear with me.) After five years of misery, you lead a rebellion, take control of the prison, and demand your release. The jailers respond by cutting off your water supply. Should you back down and return to your cell, perhaps negotiating for slightly less unpleasant conditions, in order to obtain a little liquidity? Or should you keep fighting to be free? That, in essence, is what the standoff between an insolvent Greece and its eurozone creditors is really about.

For months, Greece has had "only days" to agree a deal with its creditors before it runs out of cash. Eventually that will be true. But even if Tsipras accepted the creditors' demands, Greece would still have "only days" before it ran out of cash. The 7.2 billion euros on offer right now wouldn't even cover the Greek government's debt repayments until the end of August. And for a measly two months of liquidity, Tsipras is expected to surrender his democratic mandate: break his election promises, agree to yet more tax increases and spending cuts that would depress Greece's economy further, and relinquish his demands for debt relief.

Then the wrangling would start again. Because so long as Greece remains in its debtors' prison, it will be dependent on its jailers for liquidity and therefore expected to comply with whatever additional conditions they impose. Tsipras should not submit to this debt bondage.

Nine of every 10 euros that eurozone governments and the International Monetary Fund (IMF) have lent to the Greek government since 2010 have gone to repay its unbearable debts, which should instead have been restructured back then. But from now on, every last cent of additional funding would go to pay back debt. The Greek government now has a small primary surplus: It doesn't need to borrow, except to service its debts of 175 percent of GDP.

Yet in exchange for additional liquidity, Greece's creditors are demanding a return to the failed austerity policies of the past five years, which have shrunk the economy by 21 percent and thrown one in four people — and one in two youth — out of work. The hypothesis that austerity can cure insolvency has been tested to destruction. Another dose of it would be perverse.

As Martin Sandbu of the *Financial Times* points out, further austerity isn't even in the creditors' interests. They are demanding a fiscal tightening of 1.7 percent of GDP in the second half of this year alone. Since raising taxes and cutting spending would depress the economy — shrinking tax revenues and inflating social spending, thereby unwinding some of the budget tightening — a fiscal squeeze twice as big would be required to achieve the creditors' target, if the past five years are anything to go by. According to Sandbu, that would crunch the economy by 5 percent, perversely raising the ratio of debt to GDP by some 9 percentage points. To achieve a primary surplus of 3.5 percent of GDP by 2018, as the creditors are demanding, would require a fiscal squeeze of 8.3 percent of GDP, depressing the economy by 12.5 percent and increasing the ratio of debt to GDP by around 22.5 percentage points. Far from bringing Greece's debts down to more sustainable levels, further austerity would cause them to soar.

Why would eurozone authorities be so cruel and foolish? Because they don't really care about the welfare of ordinary Greeks. They aren't even that bothered about whether the Greek government pays back the money they forced European taxpayers to lend to it, ostensibly out of solidarity, but actually to bail out French and German banks and investors. German Chancellor Angela Merkel and other eurozone policymakers just don't want to admit that they made a terrible mistake in 2010 and have lied about it since. So they want to be seen as standing up for eurozone taxpayers' interests, and they want Greeks to put up and shut up until Merkel and her minions are comfortably in retirement, and it is someone else's problem.

Further austerity isn't the only consequence of leaving Greeks languishing in their debtors' prison. Contrary to claims that Greece shells out scarcely any interest, it pays an average interest rate of 2.5 percent on its debts, according to Joakim Tiberg of UBS, a Swiss bank — 4.5 percent of GDP in total. With prices falling by 2.1 percent over the past year, the inflation-adjusted interest rate is 4.7 percent. Worse, the debt overhang creates crippling uncertainty about how the crisis might be resolved — including whether Greece might be forced out of the euro — stunting consumption, investment, and growth. Having creditors breathing down your neck to raise taxes is a further deterrent to investment. And the debt overhang also causes deflation, making the burden even more unbearable.

The creditors' insistence on reform is also disingenuous. Greece has been run by the institutions known as the Troika — the European Commission, the European Central Bank, and the IMF — since May 2010. They have had every opportunity to insist on the reforms they are now demanding. Yet they kept on funding Greece because all they cared about was the fiscal targets (and wage cuts to boost "competitiveness"). The sudden focus on reform is primarily about forcing Tsipras to break the promises that got him elected in January.

Let me be clear: Greece urgently needs reform. Its economy is underdeveloped, hidebound, and dominated by oligarchic families who monopolize markets and suborn politics. Its public administration is corrupt and inefficient. Its legal system is dysfunctional, its tax system full of holes. Tsipras may or may not be willing to reform Greece. But ultimately, it ought to be up to Greeks whether and how they do so.

Indeed, the main sticking points between Athens and its creditors aren't really reforms, they're fiscal measures. While improving the collection and administration of value-added tax (VAT) is desirable, the creditors are also demanding a tax hike of 1 percent of GDP. That is wrong-headed, since it would hit the country's main export sector, tourism, which accounts for 18 percent of GDP.

Pension reform is also necessary as Greeks live longer and fewer workers have to support more retirees. But the country's social safety net is so threadbare that a single-slashed pension is often supporting a whole family of jobless people. So, while encouraging healthy people to continue working is desirable, pension cuts are not.

Some argue that Tsipras should sign up to what the creditors want, take the cash to pay off the looming bond payments to the IMF and the ECB, make a show of reform, and then press again for debt relief. But the notion that the creditors would then be more flexible is fanciful. In 2012, eurozone governments promised Greece debt relief once it achieved a primary surplus, but they still haven't delivered it. The Greek government has now put forward sensible plans for restructuring its debts. Unless its creditors are willing to start negotiating meaningful debt relief, Tsipras should reject any deal on offer.

Merkel ought to be as magnanimous with Greece as the United States was with post-Nazi Germany, when Washington forgave half of the West German government's debts in 1953. But if eurozone authorities won't be reasonable, unilateral default — and even euro exit — is preferable to debt bondage.