GETTING GREECE BACK ON TRACK: HOW?[1]

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The economic crisis in Greece is not a simple consequence of the recent global financial crisis, but is due to deep structural problems of the Greek economy that have accumulated over decades. Consequently, the solution to the crisis is also long-term, and consists in a series of structural reforms that will take years. The goal of these reforms is to raise productivity, both in the private and in the public sector. The increase in productivity is necessary to stem the rapid drop of incomes of Greek households, and to maintain Greece's status as a relatively rich country (25th world-wide in terms of GDP per capita in 2009, and 29th in 2010).

The necessary reforms are at the micro-economic level and concern basic institutions in the economy. We would like to emphasize three key reform areas:

- **Market liberalization and regulatory bodies**
- **Justice system**
- **Productivity-based incentives in the public sector**

The memorandum that Greece has signed with the ECB/EU/IMF "troika" in May 2010 emphasizes market liberalization, but much less the other two areas. Moreover, the memorandum's provisions on market liberalization concern mainly labor and product markets, and there is little emphasis on financial reforms. We believe, however, that in the absence of deep reforms in all of the above areas, Greece will not exit the crisis, and the austerity measures implemented so far will not bear fruit. Indeed, while austerity measures are a necessary first step to bring Greece's budget deficit under control, they are also causing the economy to contract. This raises the ratio of debt to GDP and brings Greece closer to bankruptcy. Growth requires instead the deep structural reforms that we are outlining in this article. In the absence of these reforms, the funds that Greece is receiving from its troika partners will be merely delaying bankruptcy, rather than helping Greece to grow and service its debt.

Greece's troika partners should realize that Greece's problem is not only fiscal, but structural and long-term. Hence, their current emphasis on short-run results on the fiscal front (deficit reduction, debt reduction through privatizations) should be complemented by even greater emphasis on long-run structural reforms. The troika should catalyze these reforms by providing pressure and technical assistance. While such engagement is costly and time-consuming, the alternative is much costlier: Greece will experience a deep and prolonged recession as well as significant social unrest, and the huge sums lent to it will be lost.

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[1] This article is based on a talk that we gave at the 15th Economist Roundtable with the Government of Greece. We thank Costas Meghir, Elias Papaioannou and Nikos Vettas for useful comments and suggestions.

Market liberalization and regulatory bodies

Market liberalization in Greece has received considerable attention recently, both in relation to the labor market and to the market for goods and services. Markets in Greece are heavily regulated: in 2008, for example, Greece's market for goods and services was the most heavily regulated in the OECD, and its labor market was the fifth most heavily regulated. The OECD has estimated that proper market deregulation---consisting in abolishing all inefficient regulations and enforcing rigorously the few that matter---can raise Greece's GDP by more than 15%. Similar estimates have been produced by IOBE, a leading Greek economic think-tank. These estimates indicate that the Greek economy has huge growth potential precisely because it operates so inefficiently.

The main changes that are needed in the labor market are to reduce firing costs and to facilitate firm-level agreements---both to a greater extent than has been legislated recently under the troika's pressure. These changes benefit not only firms but also workers because (a) they make firms better able to survive in a recession, and so they can limit job losses, (b) they attract investment, and so they stimulate job creation, and (c) they reduce firms' incentives to operate in the informal economy, where workers receive no protection. The liberalization of the labor market should be accompanied by better insurance and training for the unemployed, areas in which Greece lags significantly behind its EU partners.

The main change that is needed in the market for goods and services is the abolition of all obstacles to competition, such as minimum fees and profit margins, geographical restrictions to exercise a profession, barriers to entry, etc. This change will reduce the cost of producing goods and services because it will (a) stimulate competition, and (b) facilitate the entry of new producers with lower costs. The reduction in costs will raise economy-wide productivity and households' incomes.

Some measures to liberalize markets have been legislated recently under the troika's pressure. In some cases, however, the changes have been only marginal (e.g., for lawyers and pharmacists) because the government has yielded to lobbying pressure by incumbents.

Effective competition in the market for goods and services requires not only the abolition of the obstacles mentioned above, but also strong and independent regulatory bodies to prevent possible monopoly practices. Greek regulatory bodies (Competition Commission, Telecommunications Commission, Energy Regulator) have become stronger and more effective recently. Their independence from the state, however, should be strengthened further, so that they can function independently of any possible political pressures. For example, the terms of their senior staff should be staggered and end in different years so that any given government can only change a subset of them. Moreover, new senior staff that any given government nominates should be approved by parliament with a super-majority, as is the case in many other countries. Finally, the regulatory bodies should strive to implement the law in a transparent and consistent manner, and should be subject to greater accountability.

The presence of strong and independent regulatory bodies is especially important in light of the upcoming privatizations. Indeed, the increase in efficiency brought about by private management should be passed through to the prices faced by consumers.

Market reform should concern not only the markets for labor, goods and services, but also that for credit, i.e., Greece's financial system. One of the main causes of Greece's current recession is a credit crunch: Greek firms are having difficulty to borrow from banks because the latter are experiencing tight funding constraints. These constraints are partly due to the sovereign debt crisis, which has caused (a) a flight of deposits away from Greek banks and (b) uncertainty about a possible reduction in the value of Greek government bonds that banks are holding in their portfolios. The constraints are also due, however, to choices made by Greek banks, such as (a') the large credit expansion in an unstable macro-economic environment, which created a dangerous dependence on the interbank market, and (b') the investment of an overly large fraction of their portfolio in Greek government bonds, and the consequent lack of diversification in bonds of other Eurozone countries, e.g., France and Germany. The problem is due to a large extent to the close relationship between banks and the state---any given government controls directly or indirectly a large fraction of the banking sector. This close relationship hinders the effective supervision of banks by the relevant regulatory bodies, and prevents the banking system from functioning efficiently.

Reform in the banking system requires making it truly independent of the government and the politicians. Entry by foreign strategic investors in some banks, at least on a temporary basis, could be useful in that respect. And our previous remarks on the strengthening of regulatory bodies also apply here.

Greek firms could, in principle, raise capital not only from banks but also from the stock market. Unfortunately, however, the Greek stock market does not attract enough interest by investors. Attracting more investors requires strengthening the investor-protection framework. The Capital Markets Commission, which oversees the stock market, is undertaking significant steps in this direction. These steps, however, should be combined with a drastic reform of the justice system. For example, the lack of interest by investors in the stock market is not due to ignorance, but is to a large extent a rational reaction to the large number of fraud incidents during the stock-market bubble of 2000. Very few of these incidents have been prosecuted successfully. This is due to deficiencies in the legal framework, and more specifically to the short statute of limitations and to the slow pace at which justice operates in Greece.

Justice system

Reform of the justice system has not been high up in the agenda of either the Greek government or the troika; yet, it is one of the most powerful growth-promoting reforms that could be undertaken in Greece over the next few years. An efficient justice system can benefit the economy in many ways. Firms can raise capital more easily because investors will have confidence that they will not be defrauded. Firms are also more willing to invest because they will know that any disputes that will arise in the future with other firms or the state will be resolved quickly and in a predictable manner. Moreover, there will be fewer incidents of corruption, which discourage entrepreneurial activity, impede the efficient functioning of the state, and poison citizens' trust towards it.

The performance of the Greek justice system is poor and can be improved significantly. For example, according to the World Bank's 2011 Doing Business report, Greece ranked 151st among 183 countries according to the time it takes to try a civil case---this time exceeds the average time in the countries of sub-Saharan Africa. Greece also ranked 154th among 183 countries as to the quality and enforcement of the laws concerning investor protection. Under these conditions, Greece will be unable to attract foreign investment, even if it adopts the "fast-track" type methods that have been discussed recently. And it will not be able to reduce corruption, which according to Transparency International is highest in Greece among all 27 EU countries.

Improving the justice system requires reforms on many fronts.[2] For example, the discretion of judges to grant postponements must be limited: for example, judges should provide an explicit justification for granting postponements and should handle themselves cases that they postpone. (Under the current system, granting a postponement has no cost for a judge, and judges often grant postponements to avoid handling complicated cases outside of their area of expertise.) The Greek state, which often delays meeting its financial obligations towards private parties---by seeking postponements even after a final verdict have been reached---should comply instantly with courts' decisions. Courts should be computerized---this has taken place, for example, in Algeria, Botswana and FYROM recently, but the process is still delayed in Greece. The performance of each court should be measured and compared to that of other courts. The issue of measuring productivity and efficiency, however, is a broader issue concerning the public sector.

Productivity in the Public Sector

The public sector needs to be transformed from an institution hiring party supporters in exchange for votes and without any productivity incentives, to an engine of growth and an efficient provider of services to Greek economy and society. We consider this to be feasible only in conjunction with provision of incentives for promoting and rewarding productivity. The big challenge is to provide such incentives in a period that requires severe cuts in government expenditures.

Much of current public debate focuses on the need for spending cuts. What we seem to forget is that repeated uniform wage cuts, without reference to productivity, discourage and ultimately push away the most dynamic public employees, and more generally young people who could play a pivotal role in the reform of the system.

If we are to succeed in the effort to restart the economy, we must complement the discouraging message of wage reductions with a positive perspective. Such perspective can be provided by announcing that promotions and wage increases for specific civil servants are possible, but strictly linked to productivity. For example, in German universities, part of the salary is no longer guaranteed but depends on productivity and is periodically reviewed. When such productivity-linked promotions and wage increases are offered, the system does not lose its best people but some of those unable or unwilling to contribute to upgrading the public sector.

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[2] An excellent analysis of these issues by Elias Papaioannou, titled "The Injustice of the Justice System," is available at the *blog http://www.greekeconomistsforreform.com,* which hosts additional analyses of the issues treated in this article by other Greek academic economists.

The linking of financial rewards to efficiency should be extended to public bodies and agencies. Funding of public institutions should be related to quantity but especially quality of their output, using as benchmarks relevant international indices and best practices.

- Evaluation of schools may take into account PISA or university entrance exam results
- Evaluation of universities can be based on impact of their research on the international scientific community, on graduation statistics, and on their share of foreign students
- Evaluation of public hospitals can be conducted on the basis of performance statistics, such as number of cases, duration of hospitalization, success rate, and patient satisfaction
- Court evaluation can be based on indicators such as duration and cost of trials
- That of public corporations can be based on cost and quality of services, etc.

Non-performing agencies should have their managers replaced, or should be merged, or abolished, or passed over to the private sector (as in the case of public corporations), following procedures that promote competition.

In today's Greece, trust in institutions is understandably shaken. The crucial question is who is going to evaluate performance beyond the shadow of a doubt, so as to reward the most productive employees and to identify the problem cases. How can this be done when there are pockets of corruption and long-standing practices of promoting political allies, whether individuals or pressure groups? Here we can rely on two principles. One can be described as a 'transplant' to Greece of international practices promoting meritocracy and trust. The other is based on the alignment of interests of evaluators and of those being evaluated, with a focus on promoting productivity.

For the evaluation of public agencies and institutions and the adoption of performance indicators, we can rely, in some cases, on existing international evaluation agencies, whose reputation and status depend on their impartiality and adherence to high standards (e.g., accreditation agencies for educational institutions or programs). Greece can also utilize Greeks abroad, who have achieved high positions in countries that follow superior practices. Finally, there are foreign scientists and businessmen who show genuine interest to transfer international experiences and best practices. The information and communication revolution, which facilitates immigration, also makes possible to search for and collaborate with experienced outsiders.

The resulting criteria for evaluating individuals can be applied by senior managers of public sector agencies, provided that they are themselves evaluated on the basis of their agency's performance and standing, based on international standards. The efficiency of advisory committees, which should be flexible and limited to a minimum, should be assessed by the Government on the basis of their observed contribution to promoting productivity, development, and competitiveness. In this way, the incentives of employees, management, and advisory committees are aligned to a maximum degree and are focused on efficiency.

Our proposal to involve outside experts is not limited to evaluation procedures but extends to the role that the public sector can play as a catalyst for change. High-level committees, assisted by civil servants, can set up calls for research or technological proposals, cluster programs for high-tech industries, or collaboration initiatives between researchers, entrepreneurs, and financiers; or finally contests for selection of innovative business plans submitted by the private sector.

Why do we call it a 'transplant'? The term suggests that, if this works, it will lead to the creation of a pool of civil servants who will be drawing both satisfaction and professional recognition from the application of meritocratic principles, and this will in turn result in less need for involvement of outsiders in the future. It is essential to spread a culture of meritocracy and efficiency throughout the Greek public sector.

Do Greeks Respond to Incentives?

Can these objectives be accomplished? Do Greeks respond to incentives or are they doomed by their 'genes' to wasteful spending, low productivity, and corruption? More generally, is Europe divided into two groups of countries, one of 'high fliers' in which meritocracy and productivity can flourish, and another one of 'laggards' condemned to permanent misery and corruption? Very often, such strange views are voiced in public discourse and are worth examining.

We consider the 'genetic theory' of Europe very dubious. First, if Greeks had a genetic problem, they would not have been able to function and to excel in countries with developed institutions and quality control. The majority of Greek immigrants abroad, however, are not isolated losers and marginal players, but among the dynamic and successful elements of their new society. This suggests that Greeks can perform well when they find themselves in a suitable environment and when they develop trust in society's ability to apply meritocratic evaluation criteria. Second, if Greeks had a genetic problem, they would not have been able to perform even in foreign companies and organizations with foreign presence, such as the Athens airport, for example.

Third, there is a widespread perception outside Greece that, because the Greek public sector is over-indebted, the same applies to Greek households, and that the latter exhibit over-spending and excessive risk taking. This perception is not valid, however, as a recent study by Christelis, Georgarakos, and Haliassos (2010) has shown.[3]

If one examines net household wealth (i.e., all assets minus loans of all forms, even from friends and family) of Greek households aged 50 or more, one finds that its level at the lower 25^{th} percentile of the 2004 distribution was bigger than that of the US, double the average in highly developed European countries considered in the study, five times that of Germany, and close to France. Median net household wealth was comparable to that in Austria and larger than in Germany, even if below the average of highly developed European countries. At a time when US households were accumulating mortgages, older households in reckless and over-indebted Greece had the smallest participation rate in mortgages for their primary residence among all developed European countries the study considered (5.5%) despite exhibiting the second largest homeownership rate after Spain.

[3] Christelis, Dimitris, Georgarakos, Dimitris, Haliassos, Michael "Differences in Portfolios Across Countries: Economic Environment versus Household Characteristics",

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1089802.

This outlook has a lot to do with the priority attached by Greeks to acquiring, maintaining, and bequeathing homes and other real estate. Finally, after the burst of the stock market bubble in 2000, Greeks avoid stockholding risk, and exhibit one of the smallest stock market participation rates.

It is particularly surprising and noteworthy that Greeks managed to combine consistency in the management of their own assets and debts, with complete neglect of State finances, expecting the State to behave in an irresponsible way, linked to party politics.

A credible and drastic change of setting, with institutional reforms consistent with international best practices, can restore the lost confidence and energize the Greek people, who know how to respond to incentives. Greek people need as allies in this effort both individuals and institutions outside the ailing Greek system, provided that these allies have confidence in the ability of Greeks to get back on a track of rapid growth and high productivity. This effort can succeed only if financially strong European countries support it, not only with funding, tough conditions and penalties, but also with transfer of internationally recognized practices and relevant experience, and above all with confidence in the ability of their ailing partners to perform under a healthy institutional and economic environment. Generally speaking, institutional reform is an objective behind which lots of people can rally: from those who care about the progress of Greece to those who simply want their money back.

What is needed most, though, is for Greeks themselves to believe in their future. It is here that the media and the level of the political discourse play a decisive role. The necessary reforms have been linked exclusively to protests of those who are losing their exclusive privileges, and with wage and pension reductions, instead of being connected to equal opportunity and competitively priced products and services for all. It is crucial for the investment and social climate that attention be shifted, from the few who lose to the many that stand to gain from a more competitive economy, where productivity gets rewarded. Only then can we hope that Greeks will channel their resourcefulness away from aggressive bargaining and protests, which are ineffective in times of austerity, and towards the discovery of new paths to growth and economic well-being.