DEVELOPMENT IS THE ONLY SOLUTION
Seventeen Proposals for a New Development Strategy

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Abstract

Is there a strategy that can free Greece from the grip of today's unprecedented economic and social crisis and place her on a path of sustainable development and solid prosperity? The signers of this article believe that the answer is yes if the country is willing to go beyond the measures of fiscal austerity and market reform advised by the EU-ECB-IMF 'troika". *We predict that market reforms will not succeed unless they are supplemented by powerful pro-growth policies.* The real choice for Greece is not between solvency and default or between reform and stagnation; it is between prosperity and underdevelopment.

We propose for debate and parliamentary approval seventeen radical reforms that will unlock the productive forces of the economy by shifting the burden of economic development from the state to the private sector. The government will retain responsibility for defense, law and order, social justice, and a share of education and infrastructure.

The target of these reforms for the ten-year period 2011-2020 is to raise productivity from 80% to 120% of the EU-27, in line with the richer EU nations; to increase national income from 220 bn euro now to 425 bn in 2020; and to create 1.2 million new jobs in the private sector in order to provide 800 thousand positions for young people plus 400 thousand positions to absorb excess workers from the public sector. Productivity gains require *massive* improvements in four pillars of the national economy: (a) corruption and public administration, (b) infrastructure and human resources, (c) markets and competition, and (d) pensions, taxes and public debt. We perform standard growth accounting computations to estimate the amounts of investment Greece will need to meet these targets.

Great structural changes carry the large "political costs" of limiting the economic, social and political privileges of powerful interest groups. Some of our policy proposals require constitutional amendments; many of them will be deemed "unrealistic" by practical citizens searching for a cure to today's economic ills. We rely on economic science to explain why there are no cures for those ills other than painful surgery; to evaluate the costs and benefits of deep reforms; and to convince our fellow economists and the public that almost everyone stands to gain substantially from a growth-friendly strategy.

DEVELOPMENT IS THE ONLY SOLUTION
Seventeen Proposals for a New Development Strategy*

1. A GLIMMER OF HOPE?

Is there a strategy that can free Greece from the grip of today's unprecedented economic and social crisis and place her on a path of sustainable development and solid prosperity? The signers of this article believe that the answer is yes if the country is willing to go beyond the measures of fiscal austerity and market reform advised by the EU-ECB-IMF 'troika". *We predict that market reforms will not succeed unless they are supplemented by powerful pro-growth policies.* The real choice for Greece is not between solvency and default or between reform and stagnation; it is between prosperity and underdevelopment.

It may sound unrealistic to focus on growth at a time of accelerating job losses, shrinking family incomes and widespread malaise. Can Greece really service a huge public debt, now near 130% of its national income and growing by 6-8% each year, when shops are closing everywhere and jobs are moving abroad?

We propose for public debate and parliamentary approval seventeen measures of radical reform that will nearly double GDP by the year 2020, create more than 1 million jobs in the private sector, and enable the country to service its debt without a prolonged period of default. These measures will cure the deep imbalances of the economy, unlock its productive forces, and provide real opportunities for all citizens, stronger care for the weak, and solid international presence for the country.

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The current state of the Greek economy owes more to persistent overconsumption than to any other factor. According to Eurostat, in 2009 Greek households consumed 12% above the EU-27 average even though their income was 5% below, their labor productivity was

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20% below, and only 39% of them worked compared with 43% in Europe. Balance-of-payments deficits, transfers from the EU, and foreign loans paid for the high consumption until they dried up last year. The end result is a deep recession that is rapidly re-adjusting family incomes to the level consistent with Greece's productivity and employment, that is, from a per-capita income of 22 thousand euro last year to something nearer 17 or 18 thousand. *Without a strong growth effort, incomes will adjust from 95% of the EU-27 average to about 72%; Greece will regress twenty years and become Slovakia.* Wages, salaries and pensions will drop 25%; private-sector employment will contract by 800 thousand jobs; and consumption inequality between the top and bottom 10% of incomes will rise from 5.8:1 to 7:1 (cf. Mitrakos, Tsakloglou and Holezas, 2009).

This regression can be avoided if the country decides to adopt the recipe for prosperity that is working well or has already succeeded all over the globe--in Singapore and Korea, Ireland and Poland, Brazil and Turkey. The private sector bears the main burden of economic development, with the government taking responsibility for law enforcement, infrastructure and social justice.

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Can public opinion ignore short-term "political cost" and embrace the daring reforms that are necessary for the country's survival in the 21st century? It did so with Eleutherios Venizelos in 1909. If it does that again in 2010, an immediate payoff will be renewed confidence in the future of Greece on the part of investors and creditors from all over the world, starting a virtuous cycle of large capital inflows, foreign direct investment, and cheaper credit for everyone. The economy will grow as fast as it did in the 1960's or Ireland did more recently. By 2020, Greek incomes will be where the Netherlands are now and among the highest in the EU.

2. RESTORING CONFIDENCE

New development strategies, especially radical ones, cannot succeed unless domestic and foreign public opinion are persuaded that the two major Greek political parties, which will be in charge of implementing deep structural changes, are committed to suppressing the rampant corruption in government and to curing the woeful inefficiency of the state. The public is unlikely to believe in real change *unless it sees within one year from now things that never happened before*. Compelling examples would include a flood of large public works projects, and unmistakable evidence that the Greek political class is ready to give up some of their privileges, and to imprison some prominent embezzlers. Here are three proposals in that spirit; their economic consequences are analyzed later in this article.

Proposal 1: After 12 years of service, Members of Parliament retire and become ineligible for re-election or for any type of work in the public sector.
This proposal aims to discourage politics as a lifetime career and to ensure an uninterrupted flow of fresh faces into the legislature and government.

Proposal 2: Partnerships of construction companies, private investors and others are charged with building and maintaining modern networks of highways, ports, airports, railways and marinas. They pay all costs and collect all fees with complete tax relief for 30 years.

Proposal 3: Embezzlement, bribery and other serious misuses of public funds become a high crime for politicians, labor leaders, business leaders and upper-level public servants. Charges of misuse can be filed with no statute of limitations, and are adjudicated to a final decision within one year by special administrative courts. Penalties include large fines, loss of pension rights and imprisonment.

3. CORRUPTION AND PUBLIC ADMINISTRATION

The data are unmistakable: corruption in the public sector is widespread in Greece and it is getting worse. The World Bank ranks Greece 81th among 202 nations in corruption in 2008, and Transparency International puts the country at the very bottom of the EU-27 in 2009 with a score of 3.8 out of a perfect 10. The corresponding score for Cyprus in 2009 was 6.6 and for Greece in 1997 was 5.3.

Corruption in Greece has devastating consequences. Studies by the World Bank(2009), Mauro (1995), and Kaufmann(2010) show that corruption doubles the government deficit, allows 25% of all taxes to remain uncollected, discourages investment, and holds back growth by a significant amount. For example, if the Greek public sector was as efficient in the last ten years as Cyprus is now, the income of the average Greek family would be 13% higher than it is today. Alternatively, if corruption had stayed where it was in 1997, incomes today would be higher by about 8%. We estimate that the annual growth rate would increase by about 1% if Greece were to reduce public-sector corruption to the level of Cyprus.

To capture some of the gains from better governance we recommend, in addition to proposal 3, a drastic reduction in the size of the public sector. Fast-growing nations have small public sectors ranging from 11% of total employment in Turkey and Brazil, to about 15% in Spain and Cyprus, to 22% in Ireland. We recommend a reduction of the public sector from 25% of total employment now to 15% in 2015, coupled with a substantial increase in the wages of civil servants to encourage honesty, and other incentives to promote honesty and efficiency in government.

Proposal 4: Private software companies are selected in open competition to computerize within one year the operations of all government departments. Companies provide for a period of five years a fulltime technical adviser to each government department.

We expect the cost of this proposal to reach 5 bn euro.

Proposal 5: Employment in the broad public sector is reduced from 1.100 thousand to 700 thousand persons in 2015 by selling all public firms. Unneeded public servants are placed in paid leave at 80% of their salary for the first three years, 60% for the next two, together with proportional pension contributions. Special provisions are made for people older than 55.

Compensation of the 1,1 million employees in the broader public sector amounts to 13.9% of GDP or about 33.5 bn euro. We estimate that Proposal 5 will reduce that amount to 12.7% in 2011-2013, 10.8% in 2014-15 and to 10.3% in 2016 and thereafter. By then public sector wages will have shrunk by almost 8.6 bn euro, allowing the government to give substantial raises to all remaining public servants.

Proposal 6: All promotions in the public sector are based on merit as judged by supervisors' committees and by the Inspector General for Administration. Salaries of active lower-level civil servants are raised 50% above inflation within 5 years. Salaries for upper-level civil servants subject to the high-crimes code of proposal 3 are doubled by 2015.

Proposal 7: The office of the Inspector General for Administration oversees and evaluates the work of every government department, and informs the public accordingly.

We estimate that salary raises will cost the government 15 bn by 2015 at which point total compensation in the broader public sector with 700 thousand well-paid employees will have reached 40 bn, that is, 6.5 bn more than 1100 thousand public employees are paid today.

4. INFRASTRUCTURE AND HUMAN RESOURCES

Greece has failed to invest in railways, motorways, ports, or airports. The national stock of public capital is far below the EU-27 average. The country occupies 2.9% of the EU land area and represents 2.2% of its population; it has an antiquated railway network that covers 1% of the EU total, half the motorways of Portugal, and air traffic that equals 0.8% of the EU. Greek ports carry an insignificant fraction (less than 5%) of European seafreight.

Every study we know shows that investment in transport and communication is very helpful for economic growth. For example, if the policies we suggest in proposal 2 double the stock of public capital by the year 2015 (say, to 2500 km of motorways, a fast train connecting Athens with Salonica, three modern ports, five modern airports, and fifty marinas), then Easterly and Rebelo (1993) estimate that GDP growth will go up by 0.7% and total factor productivity will rise by 35-40%. Family incomes will improve about 8% within ten years.

We also know that the state of public education is dire, and the work skills of the nation are inadequate to the tasks of knowledge-based service economies. That verdict is backed by overwhelming evidence, starting from the low productivity of the labor force (80% of the EU-27 average), the poor performance of Greek 15-year old students in standardized PISA tests (ranked 28th out of 30 OECD nations in 2005), and the acute shortage of technical invention and innovation (Greece with a 2.2% population share applies for only 0.2% of European patents). Worst of all is the evidence that tertiary education simply does not pay in Greece. Going to a university is not a good investment if one seeks employment in the private sector. University degrees raise wages by only 32% or about 300 euro per month compared to 61% in the EU (Psacharopoulos 2004, 2009); we estimate the true private return on university education to be 3.5% rate of return in Greece compared to 7% in other countries.

The blame belongs to the governments and the voters of Greece who have invested in education and research about 2% less of their GDP than other European countries. The biggest problem continues to be the wasteful and unusual manner in education is administered in this country. To lift the quality of Greek education up to the standards prevailing in the most developed members of the EU, we suggest that Greece should simply emulate the educational modus operandi of those countries by decentralizing education and increasing competition among schools. In particular,

Proposal 8: All laws banning private universities and police presence on university campuses are removed. The funding and oversight of public schools and universities reverts from the Ministry of Education to regional governments. All universities are subject to a newly instituted system of accreditation that is administered as an independent authority.

Proposal 9: For a period of two years (2011-13) all tertiary public institutions are placed in a state of receivership similar to the one which prevailed in East Germany in the early 1990's. Universities are administered by committees of distinguished academics from Greek and foreign institutions who evaluate all faculty, staff and students according to international standards. Surplus faculty and staff become inactive under the terms of proposal 5; surplus students are removed from the institution and prepared for work. After two years, universities become self-governing institutions, as they are in the UK and elsewhere, with complete authority to manage their endowments, hire faculty and staff at freely negotiated salaries, set tuition and fees, decide the number of students admitted, etc.

Proposal 10: All primary and secondary institutions of public education are evaluated in 2013 by committees of Greek university professors. The number of active schoolteachers is reduced to the EU average; salaries of active teachers are raised as described in proposal 6.

We anticipate that the combined impact of proposals 7-9 will double the private rate of return on education to about 7% and contribute 0.9% to economic growth.

5. MARKETS AND COMPETITION

The Greek state regulates labor and product markets more than most EU and OECD countries. The consequences--deterred entry, limited competition, high prices--are more in line with the interests of privileged groups than with those of the average family or with the needs of economic development. Employers do not wish to hire, even in good times, because it is prohibitively expensive to dismiss workers in Greece. The Greek economy ranks 26th in competitiveness among the EU-27, the unemployment rate for young workers typically surpasses 20%, and foreign direct investment is discouraged. FDI in Greece hovers around 1% of GDP against 4% in the EU-27.

OECD estimates that lightening the burden of regulation in labor and product markets will add 15% to GDP over the next few years, and attract bigger inflows of FDI. If investment flows into Greece reach the EU-27 average, a simple growth accounting exercise shows a boost of 0.5% to the annual growth rate.

To improve the quality and effectiveness of market regulation, and bring strikes days down to the EU average strikes, we suggest the following policies.

Proposal 11: Parliament votes for a timetable that liberalizes all markets for labor, goods and services by 2015, and opens all closed professions. Laws regulating profit margins, the prices of any good or service, and minimum wages are withdrawn. All regulations restricting entry into air, sea and road transport are removed. An independent, well staffed Competition Commission is charged with the oversight of all labor and product markets. The Commission prosecutes monopolistic practices, and guarantees that competition is fair and market entry is free.

Proposal 12: Freely negotiated private-sector collective agreements are allowed for individual firms and industries but are banned for larger-scale units. Collective agreements specify wages and terms of employment, including dismissals and how they will be compensated. All government laws restricting dismissals are modified. Labor-union strikes require a majority of all union members voting in a secret ballot supervised by the Competition Commission or by a panel of judicial representation.

Data from the International Labor Organization from the period 1976-1998 show that the time lost to official strikes, excluding wildcat actions, ranged from an annual average of 0.06 days per million inhabitants in the USA, to about 0.14 in Italy and Spain, and to 0.36 in Greece.

6. PENSIONS, PUBLIC DEBT, TAXES

After three decades of large government deficits averaging 7.5% of GDP, public finances are in a precarious state as public debt nears 130% of GDP and investors are unwilling to buy long-term Greek public debt unless it pays 12% per year. The record is one of careless profligacy. In the year 2007, for example, the central government spent 45% of national income and collected less than 40% of it in taxes. Government auditors misplaced or failed to collect 25% of all taxes due. Even so, taxes on profits and retained earnings are among the highest in the EU-27. Many multinationals have already left the country and Greek-owned businesses are relocating abroad.

Government finances are worsened by the alarming state of the pension and health systems. Alone among OECD nations, Greece has no private retirement accounts while, relative to national income, Greek pensions are the most generous, paying 96% of average earnings, from an average retirement age of 58, and costing 13.5% of GDP. The corresponding OECD pensions cover only 61% of earnings starting at age 63, at a cost of only 10% of GDP.

Public hospitals operate without budgets or state supervision, prescribe too many drugs, and generate deficits of 2% of GDP or more. The public health system is a poor servant of public health: it is staffed with many unqualified professionals, greatly underpays doctors and nurses who are routinely bribed by patients desiring decent medical care. As a result, Greek women live two years less than Spanish women; fifty years ago they lived exactly as long.

To reduce the burden of the pension system on public spending, diminish tax evasion, and improve the quality of health care, we propose four reforms that will bring Greece in line with the rest of Europe, balance the government budget, increase national saving and accelerate growth.

Proposal 13: Pensioners retire at an average age of 63 and receive 65% of their earnings. Supplementary pensions from individual retirement accounts raise that amount to whatever level pensioners desire.

We estimate that central government spending on pensions will drop by 6% of GDP, from 13.4% now to about 7% in 2015, saving the government roughly 20bn euro.

Proposal 14: Pensions and social insurance shift to a system partly based on individual retirement accounts, invested as the owner wishes in domestic or foreign financial instruments (stocks, bonds, bank deposits). Everyone will have the option to stay with the current system. A small tax is levied on investment returns to guarantee a minimum pension for all.

We estimate that, over a period of ten years, up to 5% of GDP will go into IRA's. National saving will increase by roughly half that amount (Feldstein, 1974), and national growth will go up by about 0.8%.

Proposal 15: Major tax evasion is a crime punishable by fines and incarceration. Tax returns of wealthy individuals will be audited regularly and randomly by anonymous tax officials. Byuers'expense claims are automatically cross-checked against sellers' declared incomes.

We expect this proposal will cut evasion of direct and indirect taxes in half and increase tax collection by about 2.5% of GDP or about 8 bn in 2015.

Proposal 16: Public hospitals become self-governing institutions serving patients and receiving compensation from private insurers in a system of mandatory health insurance supervised by the government.

We are not able to calculate the economic impact of this proposal nor do we expect future health care to cost less in a rapidly aging society like Greece. We merely note that this is the system that serves well in many European nations.
Foreign direct investment is an important driver of economic growth all over the world. To ensure that Greece gets at least 4% of Europe's FDI as suggested earlier, and perhaps more, we endorse substantially lower taxes on all business activity, and a negative income tax to aid the working poor and pensioners. We note that Greece had the highest inequality in the EU in 2003, and the third largest fraction of people at or near poverty levels in 2008.

Proposition 17: All direct business taxes are immediately lowered to 10% as in Cyprus; social contributions are gradually reduced by one-third until 2015 and income taxes by one-half. A system of social insurance with negative income taxes guarantees an acceptable minimum income for all working citizens and pensioners.

Assuming *no* increase in economic activity, we predict the immediate cost of this policy to the government to be at most 4% of GDP (10 bn euro) in 2011 rising to 9.5% (24 bn) in 2011. An additional 4bn will be needed for income subsidies to the working poor, and 6.5 bn for the civil service raises described in proposal 5. Lower taxes, better salaries in the public sector and social spending will thus cost the government 34.5 bn in the year 2015. This amount will be partly covered by lower spending on pensions (20bn from proposal 13) and less tax evasion (roughly 6 bn from proposal 15). The remaining 8 bn will come from low taxes on the expected 75 bn increase in national income in the next five years.

Will these proposals really help the country service its debt without default? If all of them are endorsed by Greek voters, then the contributions to GDP growth from less corruption, better infrastructure, improved education, pension reform and higher FDI come to almost 4% over and above the pre-reform rate of growth which averaged about 2-3%. Adding to that a 2% inflation rate means that nominal income can grow at 8-9%, much faster than public debt. Greece remains solvent, becomes a mediterranean economic miracle and provides its citizens with equal opportunity, social justice and a better quality of life.

7. VIRTUE OR VICE?

The dire state of the economy forces Greek citizens to choose between economic virtue and economic vice. Vice is the easy way: we reform as little as our lenders will tolerate and otherwise continue life much as before with 25% lower income and consumption. The standard of living will regress to 1990 but otherwise everything will remain as we know it. The public sector will be still be bloated and corrupt, our children will still get

an inferior education, our sick and elderly will receive third-world medical care, our young will be unable to find jobs. The country will continue to serve the political class and their allies; all those who desire a future must join them or emigrate.
Virtue is the hard choice of pushing aside special interests and political dynasties, of opening the country to all those who want to work, produce, create jobs and wealth. This choice is hard because households, businesses and government will have to work more and learn to behave as though they were in a different society like Cyprus, Ireland or Germany. It is doubly hard because special interests will not surrender without fighting on city squares, highways, airports and harbors, without blackouts, closures, smashed windows, burned automobiles and a flood of strikes.

Above all, virtue means to give our children a future in their own country. Is there enough virtue left in Greece?

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