

## Greece: The Way Forward

White Paper – London, October 27, 2011

---

### Background

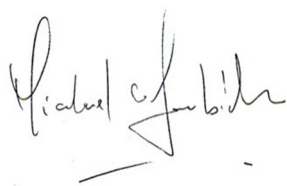
On 14 and 15 October 2011, a group of senior stakeholders, many being Greeks or of Greek origin, gathered at the London Business School to discuss the Greek Crisis. The group included:

- MPs, former ministers of Finance, Labour and Economy and economic advisors to the Greek PM from both PASOK and ND.
- Senior policy-makers and advisors both from Greece and the EU; former senior IMF executives; and part of the current and former leadership of two central banks.
- Senior bankers from Greece, the UK and continental Europe; senior lawyers specialized in restructuring and tax issues; turnaround advisors; and executives from industry and consulting.
- Academics from continental Europe, the UK and the US, with expertise in economics, finance, banking, strategy, and political science.

Our discussions covered the management and ramifications of a potential Greek default, the management of the Greek financial sector in the event of default, and how to restructure the Greek public administration and economy.

A remarkable consensus on future directions emerged, and the intention of this White Paper is to propose structural recommendations. Our primary intention is to inform the discussions among the EU, the IMF and the Commission, and Greece.

We propose some controversial but necessary policy choices. These views do not always represent the entirety of the participants, but they have been informed by the group discussions.



Michael G. Jacobides

Sir Donald Gordon Chair of  
Innovation & Entrepreneurship  
London Business School



Richard Portes

Professor of Economics  
London Business School  
President, CEPR



Dimitri Vayanos

Professor of Finance  
London School of Economics  
& Political Science

## Executive summary

Greece is balanced on a knife-edge, with a weak public administration, ambitious targets for deficit reduction and a macroeconomic contraction. We suggest that a set of new priorities for the Troika and the Greek government (and political forces alike) can be of help, through the following urgent actions.

- We propose **independent authorities** with a clear responsibility *and mandate*, working to focused Key Performance Indicators (KPI). The main ones would be: **Tax Assessment and Collection Authority; Reforms Authority; Healthcare Authority; and Corruption Initiative**. They would report to the Greek Parliament while updating creditors and the Government.
- The creditors and Greece alike should focus on the **rationalization of public authority design**, given digital workflows, and **integration of KPIs in the resource allocation process**. Firing underperforming civil servants must be allowed. Permanent Undersecretaries of State are proposed to support capacity and increase consistency.
- **Tax and customs & excise evasion** must be addressed head-on. Distance between rhetoric and reality suggests a need to start afresh, **abolishing current structures and instituting new ones**. Structural reforms including **flexible IT procurement, judicial reforms, and performance-based contracts** are essential.
- Advances in terms of accountability and transparency stall in implementation. For example, the promise of e-procurement and cost-savings systems has yet to deliver full results. For this reason, we suggest that **loans be made conditional on structural reforms**.
- The focus of the Troika on operational measures will help **legitimize the reform programme** and elicit buy-in from Greeks, who are facing severe hardship. **Creating a sense of moral justice** is paramount, especially given the turbulent political climate and incendiary social environment. **Revoking side-payments of governments to interest groups** (e.g., the indefensible €700m a year subsidy from public funds to the Electricity Company pension scheme) will help build credibility and address social fairness.
- **Privatizations** should be pursued to restructure the economy. That central objective should not be obscured by a misplaced focus on targets for fiscal receipts . We also propose the change of the privatization process through the use of **debt financing**. As uncertainties on zoning and titles are reduced, or more assets or companies are added, the debt capacity (with the assets as collateral) can increase as well, and access outside funding before credit ratings allow the Greek government to do so. The privatization fund should be bolstered substantially to increase value in assets under its management.
- Assuming a substantial sovereign debt restructuring, bank recapitalization will be needed, and our main concern for the banking sector is **how the banks will be governed – and protected from political influence**. Financial supervision must be strengthened and expanded as soon as possible.
- The authorities should consider more extreme solutions such as the institution of an **EU jurisdiction**, if this can be made compatible with the Greek constitution. This could be a complement to sorely needed changes in the **judicial system**.

- Engagement with ***civil society institutions*** to help instil confidence and involvement is also essential.

The reform programme must ***focus on implementation and engage*** more deeply with Greeks, so as to help stabilize Greece's economic situation and give incentives for investment and production. There is an urgent need to focus on operational measures and restructure the Greek public administration. While vigorous application of competition policy and reforms of the labour market are clearly important, our White Paper focuses on institutional change which has not been properly attended to. The unwillingness (and possibly the inability) to change is endemic and understandable, and we cannot wish it away.

***Ownership, communication, and engagement*** are crucial. Debt relief will demonstrate that the programme is not about protecting the entrenched interests of creditors. ***Anomie and the dissolution of public order*** are possible and extremely dangerous scenarios that would be hard to reverse. This alone ought to galvanize all political parties to work together. Since it has not, we do wonder if the gravity of the situation is understood. We advocate a new approach and hope these proposals will engender action as well as debate.

## **Current impasses and the need for structural reform**

Greece is facing a perfect storm. Structural problems of the economy and public administration, masked and neglected for decades but laid bare by the current crisis, must now be tackled. The local financial sector is jeopardized, but so is the global financial system and the Euro itself. Not only does the single currency lack a mechanism to deal with sovereign crises like Greece's, its structure exacerbates them. And all this is happening at a time of sluggish global growth (at best), following a global financial crisis, and under severe political and macroeconomic pressures.

While we discussed debt relief, we appreciate that we have little influence. Suffice it to say that the supposed 21% PSI emerging from the 21 July negotiations might have been illusory, since the actual amount depends on the choice of discount rate. It is easy to see why banks and the IIF were pushing for such a solution, but this was too good a deal for holders of Greek debt and unsustainable for the GGB owners in the long run. In the short run, EU taxpayer and IMF loans (which will have priority) have been used to pay existing debt-holders in full, including those who bought GGBs in the secondary market for a third of their nominal value (making the July PSI a potential windfall for them). So speculators would actually benefit from the preservation of an unstable status quo, funded by the IMF and EU taxpayers. Furthermore, the market had priced in a massive Greek default. With the new EBA stress-tests for "marking to market" sovereign debt, there is little value in maintaining the pretence that Greece does not need to default. Nor would it be disruptive to trigger credit default swaps, if this were the result. The 26 October European Council agreement on substantial debt relief appears to go in the right direction, but it is not possible to judge whether it is adequate without seeing precise terms and conducting a serious debt sustainability analysis, following standard IMF methodology. And implementing debt reduction must safeguard the independence of the Greek financial sector. Any restructuring should certainly *not* be linked needlessly to an exit from the Euro, a dangerous and undesirable solution for all parties.

However, a substantial haircut alone will not solve Greece's problems. Just as in a corporate turnaround, the financial restructuring should only happen once plans are made for operational transformation. Greece needs to tackle real reforms head-on – the alternative being a collapse, which would hurt Greeks and push Europe into a contractionary tailspin, especially if the monetary union were to disintegrate.

It is critical to tie the reforms to the loans Greece will still require until it achieves current account and primary fiscal balance. We propose a fairly bold departure from the current approach of the Troika. The rest of this report outlines the next steps that are urgently required.

## **Zeroing in on tax evasion: an immediate imperative with fiscal and symbolic importance**

The state of taxation in Greece is both bad news and good news. The good news is that there is huge scope for improvement: the state receives €15–20bn per year less than a "base-case" scenario based on EU-wide tax evasion levels from personal tax, corporate-income tax, and VAT. But that suggests a wide range of bad news. Admittedly, Greece has some structural difficulties that make tax evasion more pervasive, such as a very high self-employment rate and the preponderance of very small business with minimal tax reporting. But this has long been an issue, and little has changed. Tracing

back 20 years of budgets submitted to the Greek Parliament, one finds the containment of tax evasion as a main target in every single year. Meanwhile, Ministry of Finance officials had received salaries up to twice as high as those paid in other ministries. There is a widespread concern with *corruption in tax authorities*, and tax collections outside those held at source are at very low levels. Auditing and punishment of tax-evasion suspects identified by cross-checking data has progressed very slowly. Lack of progress is due to the inefficient and corrupt nature of the current mechanism. In fact, *it may be beyond salvation* – and this needs to be recognized now.

The number of tax-collection offices is much higher than in other countries. The association of tax collection officials is reacting to severe pay cuts with a ‘go-slow’, and there is widespread resistance to change, despite obvious inefficiencies. Tax offices are even being downright unresponsive to current initiatives, such as demands from the Ministry of Finance to engage in audits based on electronic assessment of potential tax-evaders. Such foot-dragging is disconcerting, especially since substantial incomes were discovered by the few audits that did take place.

The recent online publication of performance data for each of the tax-collection offices by the Ministry of Finance General Secretariat of Information Systems provoked a huge backlash, with no counter-suggestion of KPIs that should be tracked instead. There have been no disciplinary, career, or resource-allocation consequences for underperformance. Even if there were the *will* to change, and corruption could be curbed (two very big ‘ifs’), it seems that the *capability* to change is simply not present.

Those formerly responsible for the Ministry of Finance have noted, astonishingly, that even if all the tax-collecting authorities were shut down, state revenues would not suffer noticeably. Most of the taxes collected are withheld at source or paid through electronic transactions. Even the newest property taxes are not being directly measured and collected – the government relies instead on electricity bills (which are used to collect) as these report size of dwellings, with payment enforced by the threat of disconnection. This is hardly a tax policy.

*It is probably impossible to change such a system. Our proposal is to abolish it and build a new one based on current best practice, the intense cross-checking of data, and the capabilities needed. It should also be based on the sort of measures – and attitudes – that will create the ethos appropriate for a tax-assessment and collection agency. The Ministry of Finance should still set the rules for taxation, but assessment and collection should be carried out by a newly created independent agency, which should have an arm’s-length relationship with the Government.*

A new administrative infrastructure should be created, with employees on shorter-term contracts and performance-related pay. Within six months, all responsibilities and files should be transferred. Business units within the new agency will be responsible for their own results, and will be able to define their own needs and resource allocation. This will facilitate leaner structures, with flexibility being counterweighed by transparency and accountability, facilitated by IT. Each unit should be compared to others and benchmarked against them. Staff should rotate regularly across units to minimize the scope for corruption. Targeted investment in people and IT (and flexible procurement) should be made, focusing on the return on such investments. Some tax collection could possibly be outsourced to a joint venture jointly owned by Government, creditors, and specialized firms; partial use of such channels could also help in setting an additional benchmark for tax collection KPIs.

Current estimates are that a hand-off or even a total cessation of Local Tax Office activities would not be detrimental, given their limited income contribution. Similar changes are required for the customs service, which has an equal reputation for corruption. Adding more and more layers of bureaucratic approvals simply expands the scope of corruption; such practices will need to be simplified or justified. The Independent Reform Authority, discussed below, will listen carefully to proposals on how to reduce corruption; its responsiveness will generate a sense of ownership and restore some sorely needed faith in the state.

At the same time, Greece needs tax rules that are clearer, less subjective, and as such less liable to corruption. Recent examples of the subjectivity of VAT classifications (between 13% and 23%) or variations in taxes on heating and vehicle fuel provide instances of both corruption and tax evasion induced by ambiguous, corruptible, or subjective rules.

The improvement of tax collection also requires either the improvement of the justice system, or, more plausibly, the institution of a parallel branch of the judiciary, focusing on tax crimes, which will have expedited trial times. The slow legal system acts as both a shield and an incentive for tax offenders. The investments, if required, should show a remarkable return.

Tax reform is critical to the success of the Troika programme. High-profile figures with means clearly beyond their income must be prosecuted by an autonomous unit that is protected from governmental and political influence – possibly with direct Troika support. Tax is a hugely symbolic issue that can help to turn the tide of public sentiment and rebalance economic activity.

### **Reforming public administration: from generic statements to practice**

Greek public administration is one of the root causes of the problems. Not only is it consuming a disproportionate share of GDP, but it is also preventing efficient resource allocation – in either the public or the private sector. The deficit (and the resulting debt) is partially due to these underlying deficiencies. Public administration must improve the quality of public services through competition and differential reward of best practices and people. It must improve the link between the public and the private, eliminating clientelism, favouritism, and corruption. And it must reduce red tape, support the overwhelmed judicial system, remove uncertainty about taxation and regulation, and address regulatory capture.

These high-level problems are well known, and both major parties have tried to address them. Yet the issues remain and are continually compounded. Our view is that they cannot be resolved without major structural changes. This crisis is an opportunity to redesign the Greek public administration; if it is not taken, creditors will not recoup their capital, nor will Greece return to growth. Experience tells us that the “burning platform” of intense budgetary pressure does not guarantee change in and of itself. A flawed system will simply devour itself. So creditors should help the system evolve, and in so doing gain public support.

A number of positive first steps have been taken, and not all have received due credit. Legislation on transparency (such as the di@vgia programme), and the use of e-government to put all relevant public documents on the web, as well as the changes in the disciplinary code of civil servants, are important tools for change. But the impact of such initiatives is not realized because they become

mired in implementation. We cannot expect change efforts to sustain themselves when beset by entrenched interests, rent-seeking, and politically powerful media outlets.

What can Greece do to speed up change and give a positive shock to its public administration? First, most policies undertaken in a ministry depend on the ministers, who bring their senior staff with them. The lack of senior civil servants with clear accountability leads to inconsistency and missed opportunities for long-term change, given the short tenure of ministerial posts. Therefore, we propose the immediate (re-)instatement of Permanent Undersecretaries of State on all the main portfolios, each with a handful of advisors. These senior public officials will be evaluated on their achievements and be accountable to Parliament, even though they work with ministers. Their appointments, facilitated by an international search firm, should be proposed by the Board of the Reforms Authority (mentioned below) and approved by the relevant Parliamentary committee. Their advisors should also be chosen from an open call, with the input of a search firm; ASEP as well as the opengov initiative could be used as well in this process. EU officials can help to inform the nomination and selection process, in keeping with current (best) practices in other countries.

A potentially promising way to make administration responsive and accountable is to establish Independent Authorities: lean agencies focused on following up and pushing for change. This contrasts with some of the current experiences of such Authorities in Greece. So governance and accountability are key, as is *staffing them with world-class executives who are not part of the public administration and who can maintain their independence, and resourcing them properly*. We propose a five-member board, two of whom could be proposed by the Troika, and an independent full-time CEO – all appointed following a rigorous selection process and confirmed by the Parliament with a super-majority rule. Part-time board-level assignments can also enable Greece to benefit from the talent of its diaspora. It might even be preferable if most board members do *not* have their principal activities in Greece, so as to limit conflicts of interest. Getting the details of selection, monitoring, accountability, and job-specification right will drive their success.

The Independent Authorities' recommendations for change must be heeded. Their remit would be to measure, assess, monitor and report in an independent manner, and to *demand that action be taken and report to the Government, the Parliament, and the creditors when it is not*. The advantage of this institutional innovation will come from the creation of a focused, accountable "change agent", free from the current organizational structure and entrenched interests. Motivations of the administration to comply, or related sanctions, such as budget reductions, will need to be defined ex ante. Accountability will be enhanced by direct reporting to Parliament, even though progress reports will be sent to the Government and creditors.

Setting up these authorities should be informed by the successes and problems of current Independent Authorities (e.g., the Energy Regulation Authority; the Capital Market Commission; the Competition Commission), as assessed by both internal and external assessors. Similarly, there must be an explicit mechanism to audit these authorities, benchmark them with international peers and have their records assessed by independent agencies, including but not limited to auditing firms. Strong, independent leaders are also paramount for their success.

We would recommend establishing the Reforms Authority and the Healthcare Authority, as well as an Anti-corruption Agency as a matter of utmost urgency.

The Reforms Authority should have four arms or divisions. The first of these should be a change management unit that follows through and supports all structural changes in existing ministries and organizations and helps to implement change. This unit would have the right to demand compliance from any ministry or organization that was resisting change or dragging its feet, potentially by affecting the financing of non-complying entities or engaging in other measures to be defined *ex ante*. The Authority would also be free to act on information from “whistle-blowers” who highlight areas where change efforts have stalled.

The second arm of the Reforms Authority should oversee the rationalization of the overall portfolio of organizations, making recommendations to the Government in terms of merging, closing, or changing them. It will thus collaborate with the Office of the Deputy Prime Minister charged with these tasks, as well as with the Troika and the creditors.

The third arm would engage in business process redesign for particular areas of the government. The experience with the KEP (Centres for Citizen Support) illustrates that much more customer-friendly service delivery can be designed in short order. The authority should also work hard to identify Key Performance Indicators and ensure that they are visible and related to resource allocations. It should make recommendations for change if units or organizations lag behind and say how the flow of funds should be restricted if KPIs are submitted late or not linked to performance. There should also be substantial rewards for high-performing units or individuals.

The fourth arm of the Independent Reform Authority would be a bureaucracy reduction unit. This can house an initiative similar to the UK’s “Better Regulation Initiative”, open to both citizens and firms who wish to propose simplifications of bureaucratic procedures. Once a suggestion is lodged, the organization in question is required either to adopt the proposed change or explain why not. This will make organizations servants of the public, not their masters. It will also get rid of unreasonable and counterproductive procedures that impede change. For instance, in the new “one-day-process” to set up a firm, OAE (ex-TEVE), the merchants’ insurer, can require the applicant to prove they do not owe OAE money. Such irrational behaviour must be fixed – and those who are frustrated by it can help.

The second authority we propose is the Healthcare Authority. This will assist with redesigning and rationalizing the National Health Service, as well as expenses for drug and medical devices. For instance, it would absorb the recently created Drug Price Observatory, which is now being shifted from one ministry to the other, despite delivering savings of 20% on drug costs at inception. We feel that such efforts to reduce costs must be made by a truly independent agency, with a clear mandate, collaborating with the private sector inasmuch as interests are aligned. In the case of the Drug Price Observatory, for instance, insurance companies concerned about drug pricing would be invited to propose ways of mitigating drug costs or improving spending efficiency. This could help deter potential regulatory capture by pharmaceutical companies, which have benefited from the near total lack of drug repricing in the last two decades, or pharmacies, which still have some of the highest profit margins in Europe. The Healthcare Authority will thus absorb many of the responsibilities of other organizations, such as the National Drug Organization, allowing them to be restricted to technical matters. It is important to curtail the economic power of agencies that may face pressures of regulatory capture. Thus, the objective of the new authority will be to report on the *specific cost-savings achieved* in healthcare, and also on clinical and other healthcare savings achieved. Given the



excessive costs of healthcare, drugs, and medical products in Greece, and the sheer level of scandal in this area, this authority could soon yield returns.

We also support the establishment of a Corruption Reduction Agency to identify and propose measures to reduce corruption throughout public life, based on best practices around the world (the transformation in Hong Kong being one example). It could also track progress, or lack thereof, and report to Parliament, and ensure that legal cases are not halted.

An Investment and FDI Authority could also be valuable. Whereas several governmental agencies do exist (such as Invest in Greece), these have largely been PR channels for the Greek government. Our proposal is to set up a body that will exert pressure on the government to ensure its relative positions in terms of FDI protection, legal infrastructure, trade or labour policies are conducive to investment in general and FDI in particular. This Authority will not only liaise with the government, but also with the Confederation of Greek Industries, the Greek Bank Association, and other private-sector entities and the Troika. Reporting to Parliament, it will track progress in facilitating investment and entrepreneurial growth, identifying bottlenecks and suggesting how to overcome them, with the expectation of a governmental response in a given period of time.

Overall, we feel that Independent Authorities could significantly help reorganize the Greek public administration and economy, as well as instilling a sense of confidence in the state and the turnaround project. A number of the proposed authorities absorb functions that are assigned to existing organizational units; since these units are not performing, they should be scrapped.

Furthermore, the Greek government should ensure that headcount reduction and reorganization are not achieved via some blanket administrative rule such as the age limit. The government should rethink its plans to dispense with older (and more experienced) civil servants, since this risks debilitating leadership and institutional memory. Rational plans, including succession, must be instituted for layoffs.

Finally, it is imperative that the Government (and the opposition) agree to the institution of KPIs and inter-unit competition as a component of budgeting. There needs to be a *clear link to which both the government and the opposition must agree* between the KPI performance of a unit (hospital, school, museum, branch of the government) and the compensation and capital expenditure received. Institutions with superior KPIs can be rewarded with greater flexibility in terms of determining their budget and activities. Both stick and carrot should be used; the Independent Authorities must do what they can to help.

### **Owning the transformation process and a change of focus**

While many want to see such structural changes, they will not happen without external pressure, and the Troika can take the lead. It would help to acknowledge past mistakes while working more forcefully to usher in structural reforms, changing the conditionalities accordingly.

One of the main issues so far is that the Greek government has responded only to the fiscal targets of the plan, which is starting to have adverse side effects – such as the recent emphasis (by necessity) on tax revenues, as opposed to cost-cutting. The difficulties of reducing the size of the public sector have

been underestimated – and, worse, the inability to engage with rationalization is becoming increasingly evident. The Troika itself has focused excessively on fiscal targets, to the neglect of the essential structural reforms. Moreover, the political parties did endorse major structural reforms in their 2009 election programs, so there is in principle a political commitment that must be honoured. That domestic support for reforms must be mobilised.

We recommend that creditors help by explicitly refusing to accept “fiscally equivalent” measures, which usually come down to higher taxes as a substitute for cost savings. This impedes recovery and growth and avoids politically difficult changes which clash with vested interests. Refusing to acquiesce may help to increase public acceptance of the programme, even though vested interests in the government, the public administration, unions and possibly the media will resist. Scandalous practices that politicians have accepted, such as the €700m a year subsidy from the budget to the DEH pension fund, should be tackled head-on. This might be contentious, but it will increase public sympathy.

We recommend that the Troika loan conditionality be attached to the establishment of specific structural changes such as those noted above and also to progress on structural reforms, using measurable targets (e.g. number of scrapped regulations) and operational rather than aggregate or macro-economic measures. This would represent a major change of approach and attitude but could yield substantial dividends and avoid potential inadvertent side effects.

Leaders, both from the Government and the Troika, must work to widen the ownership of the reform programme. We hope that the opposition will realize that it is against its stated principles to reject the basic structural reforms the programme entails. Current conditions should allow for that. For instance, debt relief should be clearly labelled as such, and used to show that the objective of the reform programme is not just protecting creditors. Reform must be seen as the road to fairness, as there is no hope among the public at present, and this could lead to the rejection of any social order.

Public authorities and publicly owned companies must also provide data on their performance (as was recently done with the ratings of tax offices). The resulting KPIs must be shared with civil society institutions, and a fund should be created by the Troika to fund small-scale civil society programmes that increase transparency and visibility. A service that tracks, e.g., bus travel times, frequency, or driver shift performance, would help change perceptions and attitudes and increase engagement, in addition to improving organizational incentives. Similarly, the proposed fund should encourage and reward outperformance of particular units within the public administration and provide both moral and material recognition. Such units could be classes, schools, clinics, hospitals, departments, agencies, or museums. The payoffs should be seen as investments, agreed ex ante, and structured to motivate bottom-up change. The instituted changes should be used as a “best practice”. Thus small grants with flexible procurement mechanisms can yield multi-dimensional payoffs.

### **Privatizations: rethinking the structure**

The current anticipated privatization revenue, whether the original €50bn or even less, is unrealistic. International comparisons suggest that this percentage of GDP would be unprecedented. For real-estate assets, the current uncertainty in terms of tax environment and the risk of taxing property further could depress the price. Moreover, UK experience suggests that potential mass selling in a

declining market can lead to a collapse in the price of the assets. This could have dangerous side effects, as the reduction in asset value would change consumer behaviour and further exacerbate the contraction in Greece.

The group felt almost unanimously that privatizations should not be thought of primarily as a source of revenue, but more as a means to increase the competitiveness of the economy. Previous mixed experience with privatization (for buyers as much as sellers) needs to be taken into account, as does the current environment. Issues with unions should be addressed head-on, as they are still casting a long shadow on existing arrangements and depressing potential valuations.

There was widespread concern about the current privatization structure, with an agency staffed by five executives and limited resources. More important, the group felt that the process of setting aggressive targets for specific dates when cash would arrive was simply unworkable. Delays or a shortfall in receipts would lead to pressures to bridge any funding gap with extreme measures. That would further increase tax uncertainty, which is already preventing investment. So the current structure has the adverse side effect of damaging the prospects for growth. Uncertainty, partly induced by the programme structure, could drive privatization investors away with fear of unpredictable or arbitrary tax increases, for which the Greek government already has a bad reputation.

We recommend substituting debt financing for the immediate push for equity receipts. Privatization assets should be transferred to the privatization agency and then be collateralized with debt. Then, as and when sales are made over a longer horizon (about 15 years), the debt is paid down and retired.

This structure has several benefits. First, debt can be provided with clear collateral. This means that Greece can use the markets to access financing, collateralized by ring-fenced assets and businesses, and use such funds to repay its debt. Second, inasmuch as titles are cleared up, new collateral put in, or zoning confirmed, new debt can be raised. This provides an incentive for the Greek government to increase the value of the firms and real estate to be privatized in a more measured way. Third, it will avoid the risk of selling assets and companies under duress. Fourth, it will also allow the privatization agency to consider how potentially valuable assets (such as former military installations) could be redeveloped and prepared for sale, realizing a much higher value, and potentially access capital (from the capital markets) to enhance the value of its portfolio and improve business or real assets. As any potential future upside value, exceeding the value of the debt, will accrue to the Greek government (earmarked for debt relief), there will be an incentive to improve the assets under management.

This could happen either through a more traditional structure (e.g., through the current privatization agency, with appropriate resources and accountability as in the case of the HFSF recently instituted) or possibly through another structure or vehicle that combines EU/Troika and private funds. To avoid excessive leverage, a minimum rating on public debt (e.g., A) can be set. Incentives in terms of the compensation of the agency could be made contingent on the value of the assets sold, compared with international benchmarks, so as to circumvent the risk of the sale of assets or companies in depressed prices. (The concerns the Greek population and press have in terms of “selling off” formerly state owned assets should be taken seriously and addressed thoroughly through appropriate incentive mechanism design and transparency.)

The privatization agency, or any subsidiary schemes, should also have the power *and responsibility* to improve the quality of the assets that it is expected to sell. It should work with private-sector specialists to help rationalize and restructure organizations; institute corporate-governance changes; and overall improve the value of the companies to be sold, thus increasing the value retained by the Government. To do so, it needs to be seriously upgraded from a staff of a handful of executives to an organization with resources, but also accountability to improve its portfolio.

### **Rebuilding the financial services sector**

The reform programme must carefully consider the restructuring of the financial services industry. The most critical risk in a haircut is not the inability of Greece to borrow (or do so at attractive rates); it is the risk of collapse in the financial services sector, which may have dire consequences for the economy, dramatically increasing contractionary dynamics. Given that the banking system needs to be supported and probably requires recapitalization, our focus here is on how this will take place, and what this implies for governance (under the transitory regime) and financial supervision, which needs to be strengthened.

The past history of political involvement in the banking system is a particularly troubled one in Greece. Banks directly or indirectly controlled by the government often have their senior management replaced following national elections; political considerations and not economic merit have sometimes influenced the funding of projects; and the effectiveness of regulation by the relevant bodies has occasionally been hindered by the close relationship between banks and the state. We need to protect the banks, and society, from such distorting forces.

Assuming a very substantial haircut, how might recapitalization work? There already is a financial stability fund (the HFSF), which has admitted its first bank, Proton. The fund, endowed with €10bn, has a total pledge of €30bn from the Memorandum of Understanding, which could be less than what it needs to recapitalize Greek banks. More to the point, the HFSF has been set up as a short-term institution for support to the banks before they are spun off; yet the current macroeconomic conditions may require a time horizon of 3 to 5 years (as opposed to 2 to 3 years) for the firms to be privatized after recapitalization. Clear criteria for “exit” and privatization (e.g., price per book value) could be set *ex ante*.

Whatever solution is chosen (including “selling” the nationalized banks to the privatization agency after they are recapitalized and stabilized), the governance and agency issues remain. In a contractionary environment, when the government can no longer give handouts, the temptation to use the bank’s capital allocation as a lever of political power is very real

Assuming the HFSF will recapitalize the banks, we need to find mechanisms to support it. The European Banking Authority may need to be more actively involved. We are keenly aware of the attractiveness to any government to affect bank governance; and this should be avoided. Particular care must be taken to strengthen the independence of the fund further, and consider whether, as part of the conditionalities, some independent audit should be made to ensure the lack of political interference – not only for banks, but for the fund itself, which will inevitably be put under extreme pressure. A new European-level institution with the mandate to exercise corporate governance in banks (which the EBA does not have) might be helpful in supporting and complementing the HFSF in the recapitalization process of Greek banks.

A related and fundamental concern is that financial supervision should be strengthened in Greece – as noted by a number of reviews, including the IMF’s. Especially given this fragile environment, and the certainty of the fluidity for the next few months, immediate action should be taken to bolster the expertise of both the Hellenic Capital Markets Commission (capital market supervision) and the Bank of Greece (bank supervision) as it grapples with its toughest task to date. Pension funds, whose supervision was recently moved to the Bank of Greece after significant failures by their former regulator, also require attention to their performance and accountability, let alone administration. Limited but targeted investment in regulatory and possibly turnaround expertise would be very useful very soon. The HCMC, in particular, should be monitored in its role to implement the EU capital markets regulatory framework set out by ESMA.

Finally, it is important that the delays in investigating financial-fraud cases be drastically reduced, and current cases, if any, be investigated promptly. This is a further risk to the short- and medium-term stability of the sector. The poor state of the justice system with extreme delays (leading to the de facto inability to prosecute) must be tackled as an issue of priority. Funds (possibly from the fines levied) must be used to support a swifter justice system relating, at a minimum, to economic crimes, where the creation of a branch of the judiciary with expertise in white-collar crime seems eminently sensible. Even now, few (if any) fraud cases associated with the stock market bubble of 2000 have been prosecuted. This not only leads to loss of confidence by investors in the Athens stock market, but also to widespread distrust in the judicial system and the effectiveness of the state. These issues should be tackled now; and tackling them could help increase the buy-in to the reform programme, with priority given to cases involving well-known executives, politicians, or other figures in the public eye so as to restore a sense of justice.

### **Additional issues looking ahead**

In these extremely dangerous circumstances, it remains truly troubling that there is no consensus from the political parties on overhauling the state, in order to avoid collapse. Should Greece be left to its own devices, not only will the European and world economies suffer, but Greeks will be condemned to prolonged economic misery. We hope that political forces will rise to the occasion.

In terms of growth, there is a substantial amount of structural funds that Greece has not used, and these could help jump-start the stalled economy. But there is evidence of the ineffective use of these funds to date, and their adverse side effects. It might be possible to learn from experience in directing international aid in potentially corrupt countries, so the funds help strengthen the economy and are not channelled to consumption.

Other imaginative approaches could be considered. As the greatest short-term concern is the sharp contraction of the economy and the collapse of business climate, Greece needs to support new investments. One “out of the box” solution could be the establishment of an alternative business-friendly "EU jurisdiction" that individuals and companies can elect to join and operate under, possibly as a European pilot scheme. This could be responsible for all regulatory and financial management, from permits to tax and social security contributions. Those dealing with this system would not have to interface with Greek services, even though they would need to abide by Greek laws. The EU-setup authorities will give the required permits or exemptions and will hand out the proceeds they receive

to the Greek government. Although optional, this system could also help on the fiscal front by eliminating funds currently channelled to corrupt officials: companies may end up paying less and the state receiving more. Although objections on the principle of subsidiarity may be raised, it could be made less intrusive and more effective than other current treaty-changing economic governance proposals.

Overall, a viable solution to the debt problem must be accompanied by institutional and administrative reforms so as to reduce the debilitating uncertainty and risk of ad hoc taxation, which is yielding negative returns. This needs to be accompanied by greater political consensus and debate on policies, as opposed to party positions. We hope that our recommendations offer some useful ideas for the task ahead, which is nothing less than rebuilding a nation.