An Institutional Bailout Plan for Greece

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The Eurozone crisis is spreading to Italy and Spain, triggering emergency purchases of these countries’ bonds by the ECB. Italy and Spain have pledged to strengthen their economies by accelerating fiscal consolidation and structural reforms. Further support to them by the ECB is likely to be conditional on progress with reforms. But can Europe’s southern countries succeed in reforming their economies, and how should outsiders such as the ECB and the EU help catalyze change? We look at these issues in the context of Greece, where the problems are the most acute and the answers appear to be the clearest.

Greece’s bailout plan, agreed more than one year ago, is failing to meet some of its key objectives. The recession is larger than expected, and has been aggravated by a credit crunch due to banking-sector problems. Tax revenues are undershooting their targets. Progress with the necessary structural reforms has slowed down. More worryingly, while an overwhelming majority of the population backed the plan initially, support is now below 25%.

Public support is a sine qua non condition for the plan to succeed; however, it is vanishing for several reasons. The larger than expected recession and new austerity measures are perceived as evidence that the plan is failing. The lack of progress with structural reforms is causing the plan to be associated with austerity, which is primarily hitting the poorest. This adds to the existing feeling of injustice: high-profile corruption cases touching politicians and connected businessmen have not been prosecuted, and tax evasion is still pervasive and evident.

The EU/IMF/ECB troika has decided a few weeks ago to continue supporting Greece with a huge follow-up assistance plan. Yet, there are two interlinked prerequisites for the new plan to succeed that were both missing from the initial plan: the government must communicate to the public the plan’s benefits, something that so far has failed to do; and it must make real progress with deep institutional reforms. This includes reforms specified in the initial plan, such as liberalizing labor and product markets, privatizing state-owned firms, opening closed professions, and strengthening tax-collection mechanisms; but also reforms going far beyond, such as introducing accountability and incentives in the public sector (where bribed tax collectors get fined with a six-month salary freeze), strengthening the absurdly slow and inefficient justice system (where it takes many years to resolve even simple disputes and to prosecute corruption cases), enhancing policing and law enforcement, and establishing strong corporate governance mechanisms to protect minority shareholders and creditors.

Institutional reforms will have drastic growth effects because they will remove major obstacles to investment and entrepreneurship. Some of the benefits will accrue quickly; this will make it possible to relax austerity measures (e.g., those hitting low-income retirees, who experienced massive cuts) and so increase the plan’s popularity. Moreover, key institutional reforms are popular, as people are becoming increasingly aware that small minorities protected by the lack of reforms (e.g., members of closed professions, corrupt public servants and government suppliers) enjoy large benefits financed by high taxes.

Catalyzing institutional change requires modifications both to the bailout plan’s design and its implementation. The troika should emphasize these reforms even more than fiscal targets, and provide Greece with the necessary time and moderate resources to implement them. This emphasis has been missing (though with the new plan the troika seems to be taking a long-horizon strategy): for example, the plan makes little reference to improving the justice system or corporate governance mechanisms. Improvements are possible with simple policies. For example, computerizing courts will boost efficiency and transparency at a small cost. Applying restrictions on trial postponements (currently it is not uncommon for a case to be granted five postponements) will also bring large gains at no fiscal cost. Enforcing precedent by extending the applicability of “model trials” in standardized tax cases will both bring revenues and speed up justice. The examples are endless.

Institutional reforms are similarly underemphasized in the plan’s implementation. The government was pushed to make up for fiscal shortfalls through new austerity measures, which further deepened the recession. In several instances, however, where market liberalization was more limited than required (e.g., maritime cabotage, opening up of the pharmacist, notary, and lawyer professions), the troika did not put the same pressure on the government. Likewise in the current debate on privatization, the troika myopically focuses on the short-term proceeds, under-emphasizing the governance of the firms to be privatized and the competitive structure of the industries in which they will operate.

Progress with institutional reforms requires also strengthening Greece’s public administration. Lack of meritocracy, misaligned incentives, and absence of accountability have resulted in a dysfunctional bureaucracy, which is largely unable to implement the massive reforms that are required. The recent wage cuts, the salary caps for senior public officials, and the hiring freezes have compounded the problem by demoralizing existing employees and by making it hard to recruit talent when talent is the most needed. Government agencies charged with key tasks such as tackling tax evasion, designing the privatization process, and implementing product-market and financial-market reforms lack specialized personnel.

The troika should help remedy administrative deficiencies by providing technical expertise and funds earmarked for specific projects. The reforms, however, should be designed and implemented by Greeks, both from the country and from the thriving diaspora. This will enhance the legitimacy of the plan in the eyes of the public, and bring much-needed human capital from abroad that will almost surely stay after the adjustment period. Senior positions in the public administration should be filled with talented Greek technocrats, and pay should be increased. To prevent populist opposition and appointment of party loyalists, selection could be approved by parliamentary committees, perhaps by supermajority.

The emphasis on institutional reforms would clearly require additional resources by the troika. These are miniscule, however, relative to the return that they will generate: a significantly increased chance of success for the bailout plan, and the backing of the Greek people, who desperately want to see drastic changes in their country’s growth paradigm. Given the troika’s huge financial commitment to Greece, and the long-horizon of the new plan, it would be disastrous to focus myopically on monthly tax revenues or privatization proceeds, rather than on the institutional framework that will drive the long-term growth of the Greek economy.