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Growth for Greece!
Ten plus One Points for a Post-Austerity Agenda

The setting

The past six years have been hard on the Greek people, as incomes have dropped dramatically, unemployment has rocketed, and a sense of despair has taken hold. The adjustment programs that followed the balance of payments crisis of 2010 failed to stabilize the economy before 2014, and have been widely blamed as being inadequate, wrongly designed or even responsible for the crisis. Whatever the final judgment about past policies may be, it would be wrong to underestimate the adjustment that has actually taken place.

The very large twin deficits (primary budget deficit and current account deficit) have turned into surpluses. In 2014 GDP growth resumed and employment started rising. This upturn was more than a cyclical correction to a very big depression. It was also the result of many businesses adapting to new conditions brought about by the crisis and by the adjustment programs: much lower labour costs, more flexible labour markets, some removal of bureaucratic barriers, and a shift of focus from domestic demand to export markets. For example, in 2014 exports grew by as much as 8 % over the year while the rest of the economy still stagnated. In this manner recovery had started, even though fiscal policy was still becoming tighter, the overall tax burden was rising, and bank credit was scarce and expensive. It would have accelerated in 2015, as bank balance sheets were expected to expand, foreign investment to occur via privatization, and some targeted tax relief for businesses to be implemented.

This tentative recovery was interrupted by political uncertainty towards the end of 2014 and during the first half of 2015. In the course of the dramatic political struggle between the new Greek government and the institutions of the EU, business and consumer confidence plummeted again, capital flight peaked, and capital controls were put in place. Payments were disrupted; many companies lost months of sales, and investment plans froze. The turbulent climate was partly reversed in July after the Greek government reached agreement with the EU institutions for a new three-year program, and after it was re-elected in September on the basis of this agreement.

At present, the situation is both promising and precarious. In politics, the good news is that for the first time since 2010 a very wide range of forces, which represents more than 80% of the electorate, is generally supporting the adjustment program; this can be the basis of continuity in economic policy and in the reform agenda, even if governments change. The bad news is that many in the governing coalition disagree strongly with the rationale of many of the reforms, and are extremely reluctant to enact them; and that voters may react in anger to the even higher taxes that have been planned.

In the economy, the good news is that GDP has been surprisingly resilient in the light of recent events, and the year may end with a drop of less than 1% compared to 2014; tourism has performed very well; so, remarkably, did exports of locally produced goods (excluding ships and oil products). In the banking sector, recent estimates indicate that the recapitalization needs, though massive, are somewhat lower than expected. The bad economic news is that fiscal targets may not be met, as businesses and households are unable to pay all taxes. That will derail macroeconomic adjustment, with unpredictable consequences.

By and large, the Greek economy appears to be in a post-austerity stage, in which all spending bubbles of the prior decade have been more than removed, with a loss of roughly one quarter of GDP notably in those sectors of the economy that once produced non-traded goods and services for deficit-driven public and private demand. The great task will now be to make the economy grow again, but this time on a stable and sustainable path that is firmly rooted in competitive world markets. In essence, this involves a fundamental structural change of the economy from the domestic sphere to the outside world or, in economists' jargon, from the "non-traded goods sectors" to the "traded goods sectors" of the economy.

For this to happen and to accelerate in a sustainable fashion, however, a coherent set of reforms is needed. In the following points, we summarize the barebones of an appropriate reform agenda. Note that we consider items 9 (Deregulation of Domestic Services) and 10 (Debt Restructuring) to be less of an urgent priority than the rest, even though the first of these has been high on the agenda of the EU institutions, and the second very high on the agenda of the Greek government. Neither of the two will make as much difference in the medium term as the first eight items. Both of the two should be considered not at the start, but towards the end of the reform agenda.

We consider this to be a pragmatic plan of economic common sense, not an ideological manifesto from whatever political corner of the political spectrum.

The Agenda

1. **Small & medium-sized enterprises (SMEs):** The Greek economy largely consists of SMEs, and this is very unlikely to change in the future. This is why a sustained recovery of the Greek economy must come from the growth of SMEs, including new business ventures ("start-ups"). All efforts have to be focused on achieving this fundamental policy aim. Given (i) the relatively high level of education and skills of the Greek labour force and (ii) the high degree of entrepreneurial spirit with an unusually large share of self-employed, which make up roughly one quarter of total employment, the supply conditions in the markets for labour as well as product ideas and innovations are not at all bad for a sustained expansion, if only demand will be forthcoming under competitive conditions. Politically, it is extremely important to make this clear to the public – as a major message of an optimistic, but also realistic narrative on the country's future economic potential.

2. **Banking & Finance:** Greek banks have to be recapitalized quickly and decisively – making use of the rescue funds of the EMS. Most importantly, the confidence in Greek finance by domestic and foreign investors, asset holders, private business and the public at large must be restored. Any doubts about the major banks' liquidity and solvency must be removed – inter alia by the projected raising of the capital ratio of risk-weighted assets to a standard 8 %, which requires a hefty 15 Billion Euro according to recent estimates (which is 10 Billion Euro less than what had been anticipated earlier this year). Even after recapitalization, banks may be hampered in their role as lenders to business by the complexities of dealing with non-performing loans; to address this, the creation of a "bad bank" under separate management should be considered within 2016, making use of the remaining 10 Billion Euro that had been budgeted. In addition any remaining doubts about the future commitment of Greece to stay in the Euro zone must also be removed. The threat of capital controls, bank holidays and currency reforms ("Grexit") must become a matter of the past so that notably SMEs can reasonably tap financial markets again for funds and equity.

3. **Export-orientation of SMEs:** Given the size and per-capita income of the Greek economy, the current levels of exports of goods and services are much too low, at 33% of GDP (i.e. 17% goods and 16% services). They must be increased if whatever future growth is to be sustainable. Therefore, an overall priority of government policy must be to enable SMEs and start-ups to grow into world markets. This is best done by (i) removing all bureaucratic obstacles that might hinder export activities; (ii) providing

pragmatic public service support, if requested, by chambers of commerce & industry to those SMEs and start-ups that try to set a foothold in foreign markets; and (iii) reforming taxation in a way that is conducive to innovative market exploration and refraining from raising the tax burden on main Greek export branches like tourism, which faces tough competition from Mediterranean neighbours, and shipping, which is altogether footloose.

4. **Tax Rates & Tax Administration:** The tax system must be reformed in a way that is highly conducive to the sustained growth of SMEs and start-ups. In particular, it should allow up-front investment into innovative products, processes and research to be treated generously; it should keep personal income taxation as low as fiscally possible so as to avoid stifling incentives for small business and management; it should refrain from any form of advanced taxation of profits that are predicted, but not yet realized; and the "tax wedge" on wages, which is among the highest in the world, should be reduced as soon as practicable. The notoriously deficient tax administration must be massively improved so that, at a given level of taxation, a maximum of tax revenue should be forthcoming. However, the limits of fighting tax fraud should also clearly be recognized: it is an illusion to think that public budgets can be balanced just by fighting the black economy hard enough as the experience of other countries with a presumably well-working tax administration do show. Clearly, making the economy's tax base expand by genuine growth deserves priority over scratching out a given tax base to the limit of government's physical capabilities.

5. **Privatization of State-owned Firms:** To the extent that public enterprises provide marketable goods and services, they should be privatized in due course. The major aim of privatization is to achieve a maximum of economic efficiency, sustainable growth and competitive employment for Greece in the long run. Generating public revenues from sales is, if at all, a minor secondary motivation - not least because once-for-all privatization proceeds bring no more than strictly short-run relief for the public budget. Accordingly, privatization should proceed without undue delay, but in a well-organized and professional way that avoids all too hasty decisions and takes account of the actual conditions in the market for mergers and acquisitions. In general, privatization must be viewed as another brick stone – though an important one – in creating a more competitive and innovative economic environment.

6. **Foreign Direct Investment (FDI):** With a high level of education of its workforce, a by now moderate level of labour costs and a large pool of entrepreneurial talent, Greece has the potential of becoming a major target for

foreign direct investment – notably in those industrial and service branches like horticulture, pharmaceuticals, tourism and others where it has already developed substantial innovative capacity. To tap this potential in the coming years is extremely important not only to enlarge productive potential, but also to re-establish business confidence after a prolonged period of political turmoil. For that matter, the creation of an "institution for growth" that explicitly aims at attracting foreign investment might be of great help. This is one area where semi-public development banks from Europe or individual countries (like the German "*Kreditanstalt für Wiederaufbau*") could find a fertile ground for long-term support for Greek economic growth.

7. **Efficient Public Services:** By international standards, Greek administration and bureaucracy are much too slow and complex as well as susceptible to corruption. This is a particular burden to small business and start-ups who do not have levers of own power to by-pass red tape and obtain fast and reliable decisions. In this respect, a thorough reform is needed to improve overall governance. It must start by (i) redefining administration as a service to citizens and business who are clients and not subjects, (ii) evaluating all branches of government activity in terms of their importance and urgency, and (iii) shifting the criteria of employment in the public sector from traditional-style affiliations to parties and families to quality and motivation of service. In this respect, best practice examples are easily available internationally, e. g. from Switzerland or Scandinavian countries, which have a well-deserved reputation for transparent and efficient civil service.

8. **Budget Balance of the Public Sector:** To regain credibility in global capital markets, the Greek government must preserve a reasonably tight budgetary stance over years to come. In particular, a slight surplus in the primary budget (excluding debt service) will be indispensable. However, in their actual handling of fiscal targets for Greece, creditor countries and the Greek government should take a close look at the composition of expenditure – putting a much higher weight and priority on investment in a broad sense than on consumption spending. Also, the cost of reforming and restructuring the public sector along best practice lines must properly be taken into account as it possibly requires not only the early retirement of parts of the older generation of bureaucrats, but also the recruiting of younger staff, which will burden the budget. Hence a somewhat flexible, growth-oriented budget policy would be much preferable to extremely stiff numerical rules, which might lead to a massive collateral damage in the professional governance of the country.

9. **Deregulation of domestic service markets:** Restrictions to business models and a thicket of detailed and contradictory rules sustain high cost and low quality services in domestic trade, transport and professional services. This is still the case today, despite several laws that have been enacted in recent years. In some cases it is oligopolies that benefit and in many others it is large numbers of small, inefficient providers, at the expense of consumers and the wider business economy. In the long run, productivity and welfare suffer from this, so these reforms should be patiently implemented. However, they will not have a substantial impact on growth in the next few years. And, since every government has a limited capacity for reform, they should not be squeezed into a short time frame, as in the case of the previous items.

10. **Debt Restructuring:** For much too long in the recent past, the political and public attention has been hooked on one macroeconomic question: whether and to what extent the Greek debt burden will be sustainable in the long run. Obviously, this question cannot be answered with any degree of precision as long as the growth potential of the Greek economy has not been unleashed by the measures we propose (and maybe additional ones that are not on our list). To be sure, it makes a huge difference in terms of sustainability whether the long-term trend growth will happen to be 1 % or, say, 3 %. Since the debt-rescheduling from December 2012, however, it is safe to say that, at least until about 2022, the debt service will be bearable (and as share of GDP not much different from the one of Portugal). Hence, for the time being, the smartest strategy for the creditor nations and Greece itself is to go ahead with a growth strategy as proposed here and then, say, by 2020, check whether the Greek economy converges on an upper or lower growth track. Before then, debt rescheduling would not have much value, and it would not be based on sound macro- and micro-economic data.

    Final item: The New Mind-set. Not backward-looking austerity, but forward-looking growth has to become the new mind-set of the Greek people. This is a political and psychological task of utmost importance. It is important for the Greek economy, but also for Greek society at large. After the first half of this decade has been a period of traditional-style belt tightening, the second half must become a time of reform that transforms Greece into a modern economy and society in a globalized setting. This is not only important for Greece, but also for Europe at large. So we call on Greece's EU partners, also, to enable and to encourage this shift.