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Angelos Kotios, George Galanos and Manolis Koutoulakis

# How Greece's Systemic Weaknesses Limited the Effectiveness of the Adjustment Programmes

This paper examines the main systemic weaknesses of the Greek economy – structural, institutional and political – and assesses whether they were taken effectively into account in the design and implementation of the three adjustment programmes. We conclude that the economic policy mix that has been implemented through the memorandums focused mainly on treating the symptoms of the crisis instead of decisively dealing with its deeper causes.

When the first adjustment programme in Greece was launched in 2010, the Greek economy suffered from high public debt, accumulated competitiveness problems, a bloated and inefficient public sector, and rigidities and distortions on the supply side of the economy, especially in the labour, money, goods, and services markets.<sup>1</sup> A typical manifestation of these problems was the entrenchment of the so-called twin deficits, consisting of the fiscal deficit and the current account deficit, which had been increasing in lockstep throughout the entire 2000s. Therefore, a comprehensive consolidation of the Greek economy ought to contribute both to fiscal consolidation and to boosting the competitiveness of the Greek economy, thereby restoring internal and external balance.

Based on this assessment, the adjustment programmes set out two short-term objectives: first, restoring fiscal balance, and second, ensuring financial stability and li-

quidity in the economy.<sup>2</sup> The medium- and long-term objectives were to ensure the Greek economy's recovery and the servicing of Greece's debt, to improve the competitiveness of the Greek economy, and to restore external imbalances.

The main economic policy measures chosen for achieving the aforementioned objectives fell under the following categories:

- The containment of government expenditure and the increase of tax revenues, along with the gradual increase of primary surpluses;
- Internal devaluation, through the reduction of wages, profits and other types of income, with the ultimate goal of reducing domestic consumption and the prices of internationally tradable goods and services, in order to promote export growth and import substitution;
- The opening of goods, services, capital and labour markets, as well as a wide array of changes and reforms in the public sector, which were dubbed structural changes, with special emphasis on deregulating the labour market and reducing the role of labour unions;
- An ambitious programme for the privatisation of state-owned enterprises and other state assets.

<sup>1</sup> A. Kotios, G. Galanos, G. Pavlidis: Greece and the Euro: The Chronicle of an Expected Collapse, in: *Intereconomics*, Vol. 46, No. 5, 2011, pp. 263-269; S. Roukhanas, P. Sklias (eds): *The Greek Political Economy 2000-2015*, Delft 2017, Eburon.

<sup>2</sup> European Commission: *The Economic Adjustment Programme for Greece*, in: *European Economy Occasional Papers*, No. 61, Brussels 2010; European Commission: *The Second Economic Adjustment Programme for Greece*, *European Economy Occasional Papers*, No. 94, 2012; European Commission: *Third Memorandum of Understanding*, 2015, available at <http://online.wsj.com/public/resources/documents/greecedoc.pdf>.

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The objectives and means of the adjustment programmes determine the philosophy of economic-political intervention. The philosophy adheres to the traditional IMF prescription but is also adapted to the institutional and actual limitations imposed by the eurozone, the member states of which do not possess the means for implementing expansionary policies designed to support demand and investment through Keynesian policies.<sup>3</sup>

This has led to the economic policy of the memorandums aimed at reducing aggregate demand while simultaneously enhancing the mechanisms and operation of the free market economy. In other words, it adheres to the supply-side economics philosophy of modern neoliberalism.

According to the predictions of the adjustment programmes, the recessionary effect of the restrictive fiscal policy would be temporary, since the economy would be gradually affected by countercyclical (i.e. growth-inducing) dynamics, such as:

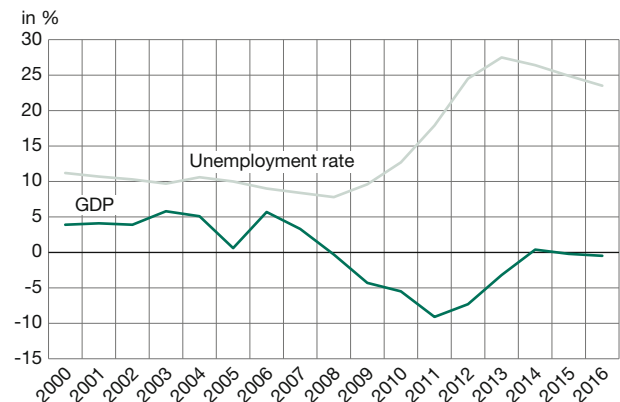
- The emergence of so-called “non-Keynesian” growth effects,<sup>4</sup> as consumer demand would increase because of the anticipated reduction in taxation following the successful completion of the fiscal adjustment. Concurrently, investment would grow because of the reduction of the public debt and the subsequent reduction in consumer, mortgage and business lending rates (i.e. the confidence effect). At the same time, the decrease in consumption would facilitate the growth of total savings and investment.
- The growth of external demand and exports, following the drop in export prices as a result of internal devaluation, as well as the growth of internal demand as a result of import substitution.
- The growth of investment, especially foreign direct investment, due to the improvement of the business environment through privatisations; the liberalisation and deregulation of the markets for factors of production, goods, and services; as well as through the modernisation of the public sector and the improvement of its services.

After the public debt bubble burst, past international experiences led economists to believe that the economy

3 A. Kotios, S. Roukhanas: The Greek Crisis and the Crisis in Eurozone's Governance, in: P. Sklias, N. Tzifakis (eds.): *Greece's Horizons*, Berlin 2013, Springer, pp. 91-105.

4 F. Giavazzi, M. Pagano: Non-Keynesian Effects of Fiscal Policy Changes: International Evidence and the Swedish Experience, in: *Swedish Economic Policy Review*, Vol. 3, No. 1, 1996, pp. 67-103.

Figure 1  
GDP growth and the unemployment rate in Greece, 2000-16



Source: AMECO Database; own calculations.

would be in recession for a certain time period, but that this would be followed by a period of sustained recovery that would improve the sustainability of public debt levels and the debt-to-GDP ratio.

This expectation, though, was belied by reality. As Figure 1 indicates, with the exception of the year 2014, Greece suffered a recession that was stronger than anticipated. The result was a cumulative GDP loss of more than 25%, causing unemployment to soar and leading to the emergence of severe social problems. Meanwhile, despite the serious fiscal consolidation efforts, the country's debt-to-GDP ratio rose instead of falling.

Obviously, the situation on all levels and metrics would be much better if the Greek economy's recovery had been faster and in line with the original working hypotheses regarding the growth dynamics of the adjustment policy. The non-emergence of these growth effects could be due to many factors, for example the political and macroeconomic instability and uncertainty, systemic risks such as the threat of a “Grexit”, delays in privatisations and reforms, as well as negative externalities. As mentioned previously, many observers believe that the persistence of the recession is due to the rapid contraction of domestic demand, itself the result of drastic fiscal austerity and the drop in real wages.<sup>5</sup> Thus, fiscal austerity entailed multipliers that were higher than anticipated,<sup>6</sup> triggering a recessionary vicious circle in which government spend-

5 E. Niemeier: “Rettingsprogramme” für Krisenländer verschärften die Krise – eine Replik, in: *Wirtschaftsdienst*, Vol. 96, No. 1, 2016, pp. 64-69.

6 O. Blanchard, D. Leigh: Growth Forecast Errors and Fiscal Multipliers, in: *American Economic Review*, Vol. 103, No. 3, 2013, pp. 117-120.

ing cuts and tax hikes caused the drastic reduction of aggregate demand, output and overall GDP. This in turn led to the further deterioration of the fiscal situation and the imposition of new austerity measures, which perpetuated the vicious circle. On the other hand, aggregate demand was also greatly affected by internal devaluation, i.e. the reduction in real wages that led to the contraction of disposable incomes and caused unemployment to increase instead of decreasing.<sup>7</sup>

In regard to the second medium-term strategic objective, i.e. boosting Greece's competitiveness, the evidence presented by the annual reports of the World Economic Forum show that, despite the drastic internal devaluation, this objective is also far from being realised.<sup>8</sup> From 2008 to 2016, the country's competitive position deteriorated, as Greece fell from 67th place in 2008 to 86th place among 138 countries in 2016. It is also telling that the country's position has deteriorated in ten out of 12 competitiveness pillars, with the worst performance shown in the categories of Financial Market Development, Macroeconomic Environment, Labour Market Efficiency, Goods Market Efficiency and Institutions.

Finally, with regard to the third strategic objective, i.e. restoring external balance, the country's large external deficits were gradually eliminated after 2010, and in 2015 Greece showed a small current account surplus. However, this was not due to the growth of exports as a result of increased competitiveness or import substitution, but primarily to the large decrease in imports – which is solely the result of internal devaluation and domestic recession, which led to the drop in demand for imports.<sup>9</sup> Moreover, the fact that exports fell in certain years, despite the relative recovery of international trade, is very alarming, as it suggests that the competitiveness of the Greek economy deteriorated rather than improved.

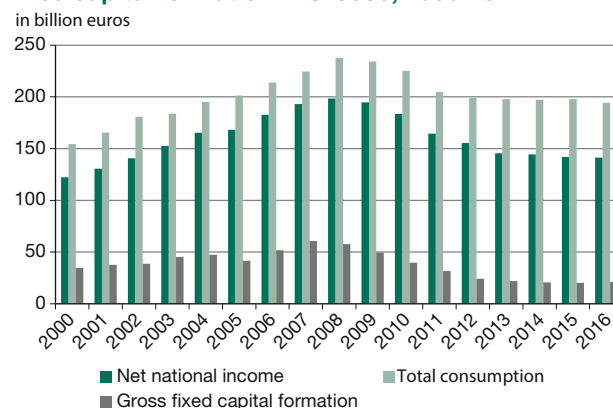
In conclusion, the economic policy set out in the adjustment programmes failed to achieve its key objectives, such as helping the economy recover and ensuring the sustainability of the public debt, enhancing the economy's competitiveness, and restoring external balance by

7 P. Heimgartner: Did Fiscal Consolidation Cause the Double-Dip Recession in the Euro Area?, wiiw Working Paper 130, October 2016, The Vienna Institute for International Economic Studies (wiiw), available at <https://wiiw.ac.at/did-fiscal-consolidation-cause-the-double-dip-recession-in-the-euro-area--dlp-3988.pdf>.

8 World Economic Forum: The Global Competitiveness Report 2016-2017, available at [http://www3.weforum.org/docs/GCR2016-2017/05FullReport/TheGlobalCompetitivenessReport2016-2017\\_FINAL.pdf](http://www3.weforum.org/docs/GCR2016-2017/05FullReport/TheGlobalCompetitivenessReport2016-2017_FINAL.pdf).

9 M. Hennigan: Europe's Worst Exporter: Poor export performance of Greece, Finfacts Ireland, 29 January 2015, available at [http://www.finfacts.ie/irishfinancenews/article\\_1028650.shtml](http://www.finfacts.ie/irishfinancenews/article_1028650.shtml).

Figure 2  
Net national income, total consumption and gross fixed capital formation in Greece, 2000-16



Sources: AMECO Database and OECD data; own calculations.

boosting external demand. At this point, the question is whether the chronic structural weaknesses of the Greek economy and certain chronic ills of the Greek economic system contributed to the failure to achieve the strategic targets of the adjustment policy, especially in regard to competitiveness and recovery.

### The predominance of consumption against savings and investment

The substantial economic growth rates that were recorded following Greece's accession to the European Economic and Monetary Union were primarily due to the associated increase in domestic consumer demand, which was fuelled by borrowing from abroad at low interest rates.<sup>10</sup> In contrast, both savings and investments declined as a percentage of GDP during the same period. After the advent of the crisis and the implementation of the adjustment programmes, it was no longer possible to finance consumption by borrowing from abroad, and thus demand-driven growth came to an end. Therefore, the main objective since then has been to transfer resources from consumption to investment in order to enhance the country's productive base. As shown in Figure 2, despite the fact that total consumption has been reduced, it still is higher than net national income (NNI), whereas total investments still account for a much smaller portion of NNI.<sup>11</sup>

10 A. Kotios, G. Galanos, G. Pavlidis, op. cit., pp. 264-265.

11 H.-W. Sinn: The Greek Tragedy, in: CESifo Forum, Vol. 16, Special Issue, June 2015, pp. 5-35, available at <https://www.cesifo-group.de/ifoHome/publications/journals/CESifo-Forum/Archiv/CESifo-Forum-2015.html>.

The credit crunch also played a major role in this. Between 2010 and 2016, the amount of money (M3) was reduced by 36% and total bank credit by 30%. At the same time, there was a significant increase in real interest rates.<sup>12</sup> Therefore, in practice, monetary policy in Greece has been restrictive, leading to a drop in deposits, capital flight, bank problems, high interest rates and ultimately the imposition of capital controls and an extra bank holiday. One of the results of the Greek crisis was the repeated outflow of deposits as a result of political uncertainty and the Greek economy's negative prospects. In periods of political and economic instability – along with the imposition of tax and fiscal measures – private capital tends to flee the country. In such a credit crunch environment, it is impossible to finance the economy and facilitate its recovery. In turn, the drastic reduction of liquidity in the Greek economy triggered a credit-recession vicious circle, in which the reduction of liquidity led to recession, which in turn made loan servicing more difficult and led to capital flight, thus further worsening liquidity conditions and exacerbating the recession.

In conclusion, successive adjustment policies reduced total consumption but did not improve the investment-to-GDP ratio. As a result, the previous economic growth model was, to a great extent, preserved.

### The Greek economy's introversion and low output elasticity

In Greece, as well as in the other countries where adjustment programmes were implemented, internal devaluation was designed to promote export growth and import substitution, which would offset the drop in domestic demand and any loss in output. Contrary to what happened in the other countries, internal devaluation in Greece contributed to the contraction of both demand and output but failed to deliver the desired results in terms of export growth, resulting only in a decrease in imports. The question therefore is why, despite the substantial reduction in real wages, Greek exports failed to grow. Empirical data analysis leads to the following findings.<sup>13</sup>

First, a large part of the decrease in wages offset the excessive nominal wage increases that had occurred prior

to the crisis. Therefore, any real decrease can only be observed after 2012.

Second, the decrease in wages did not result in a substantial drop in Greek export prices, possibly due to increases in other production costs that more than offset the decrease in wages.

Third, the introverted structure of domestic production is dominated by non-tradable service sectors, as well as traditional manufacturing and service sectors, with limited export orientation.<sup>14</sup> Manufacturing accounts for a very small portion of GDP, while the economy is dominated by sectors with limited technological inputs and low international competitiveness. Moreover, Greek manufacturing and distribution firms are among the least integrated in international production and distribution networks, and as a result they are unable to take advantage of the international dispersion of production and participation in international sales chains.<sup>15</sup>

Fourth, the small size of most Greek enterprises is an obstacle to international integration. More specifically, Greece has the largest proportion of self-employed individuals in the EU (more than 30%), and also has the highest percentage of small enterprises (those with fewer than ten employees).<sup>16</sup> Both self-employed individuals and SMEs produce for the domestic, and not the international, market. After the advent of the crisis, SMEs proved unable, because of their limited financial resources, staff and experience, to shift towards exports. It should be noted that there was no active policy for the creation of export-oriented networks and clusters, especially in the sectors that were hit harder and showed a significant degree of overcapacity (e.g. construction materials, construction or durable consumer products such as furniture).

Fifth, the sectoral and geographical structure of Greece's external trade is not conducive to dynamic export growth. This is partially due to the fact that, with the exception of tourism and shipping, Greece's export specialisation and competitiveness are low, and partially because a large portion of the country's exports are directed to countries with less dynamic domestic markets.

Sixth, export growth requires the existence of export credit, which naturally suffered a significant reduction

12 D. Gros: Where is the credit crunch in Greece?, CEPS Commentary, October 2015, available at [https://www.ceps.eu/system/files/CEPS%20Commentary%20Credit%20Crunch%20Greece%20D%20Gros\\_0.pdf](https://www.ceps.eu/system/files/CEPS%20Commentary%20Credit%20Crunch%20Greece%20D%20Gros_0.pdf).

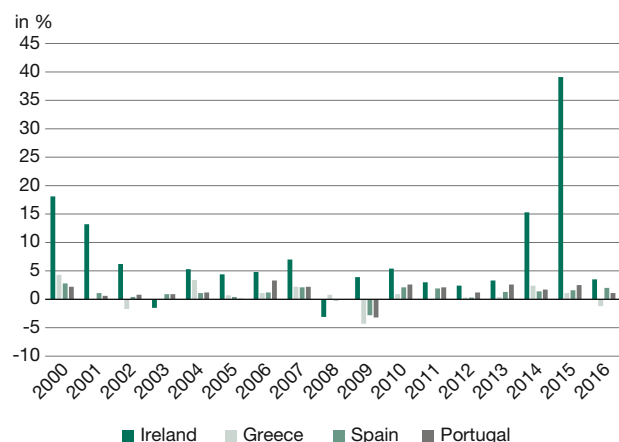
13 T. Pelagidis: Why Internal Devaluation is Not Leading to Export-Led Growth in Greece, Brookings, 12 September 2014, available at <https://www.brookings.edu/blog/up-front/2014/09/12/why-internal-devaluation-is-not-leading-to-export-led-growth-in-greece/>.

14 K. Brenke: Die griechische Wirtschaft braucht eine Wachstumsstrategie, in: DIW Wochenbericht No. 5, 2012, pp. 3-15.

15 N. Foster, R. Stehrer, M. Timmer: International Fragmentation of Production, Trade and Growth: Impacts and Prospects for EU Member States, European Economy, Economic Papers 484, European Commission, 2013.

16 K. Brenke, op. cit., pp. 9-10.

**Figure 3**  
**Contribution of exports to GDP growth, selected countries, 2000-16**



Sources: AMECO Database and OECD data; own calculations.

after the outbreak of the crisis. Between 2010 and 2016, bank credit to the trade sector decreased by about 45%.

In conclusion, in the case of Greece, structural weaknesses prevented an increase in exports, which could have contributed to economic growth, as it did in other countries in crisis (see Figure 3).

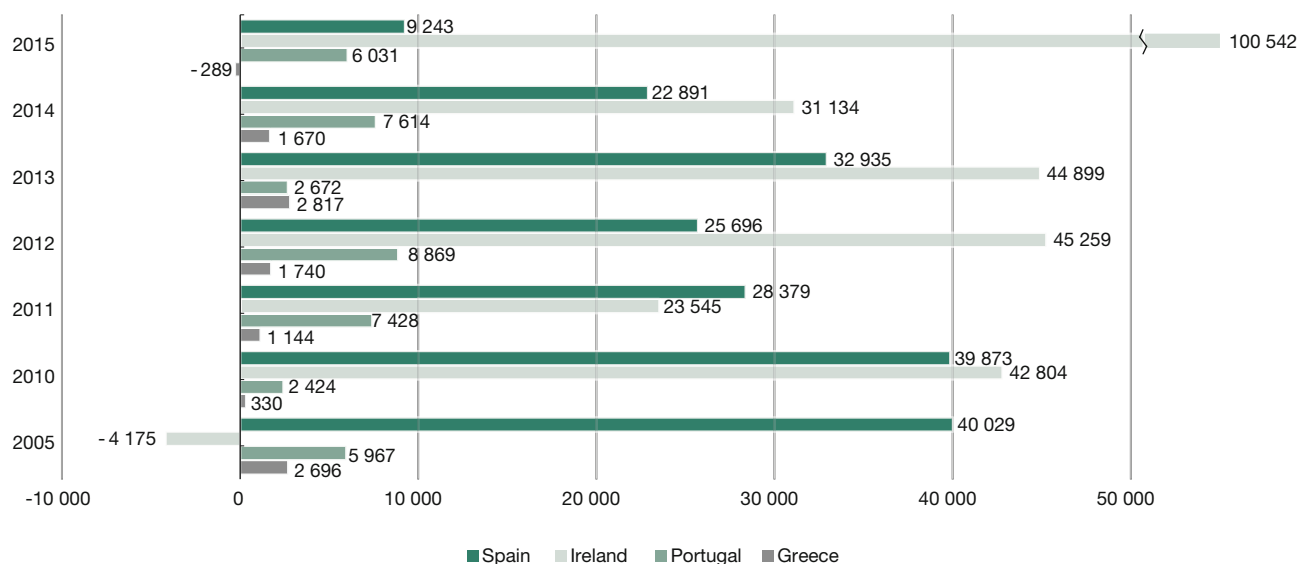
### The systemic causes of low international investment attractiveness

One of Greece's chronic problems is its low international investment competitiveness. Compared with other EU members, as well as other countries of southeastern Europe, Greece shows a chronic inability to attract international investment. Thus, in the period 2004-2010, average annual FDI in Greece accounted for a mere one per cent of GDP. The corresponding average stood at 3.7% in the EU, and two per cent in the countries of southeastern Europe.<sup>17</sup> Also, as shown in Figure 4, Greece falls far behind in attracting FDI compared to other countries that implemented adjustment programmes (e.g. Ireland, Portugal) or faced financing problems (e.g. Spain).

Greece's poor performance in attracting investment, which was already evident prior to the 2009 crisis, is due to endogenous economic, institutional and political factors, which act as obstacles within a competitive international environment.<sup>18</sup> According to the World Economic Forum's Global Competitiveness Report, and as shown in Figure 5, Greece's overall competitive position deteriorat-

**Figure 4**  
**Foreign direct investment inflows, selected countries**

in millions of dollars

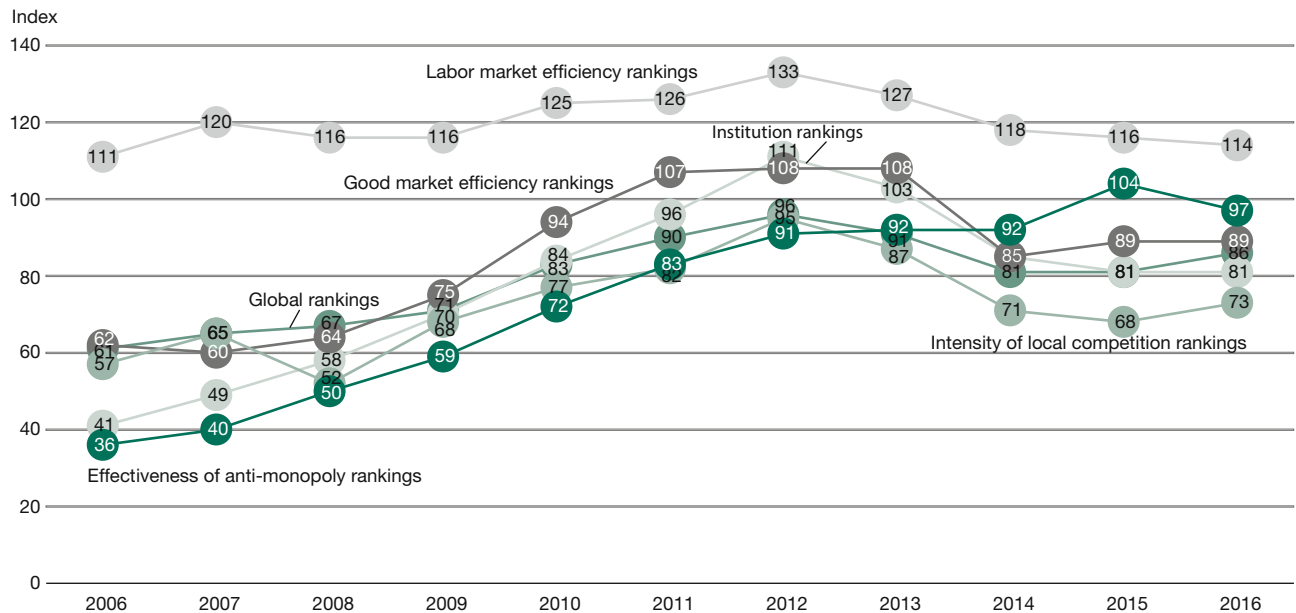


Source: UNCTAD World Investment Report 2016.

17 The Boston Consulting Group: Hellas '20:20. Supporting investment in the Greek economy – a foreign investor perspective, 2011, available at <http://invgr.com/site/wp-content/uploads/2011/12/FDI-Study-13.11.2011-ATH.pdf>.

18 IOBE: The Greek Economy, in: Quarterly Bulletin No. 75, Athens 2014, Foundation for Economic & Industrial Research (IOBE).

Figure 5  
Global competitiveness – Greece, 2006-16



Source: World Economic Forum, 2001-2016.

ed significantly from 2006 to 2012; it did show a slight improvement in 2013-2015, only to deteriorate again in 2016, ranking the country in 86th place among 138 countries.<sup>19</sup> With regard to individual indicators that reflect the major key parameters of the economic system, we can see that, despite the slight improvement over the past few years, they are still far below pre-crisis levels and, therefore, continue to drive away investors.

Despite seven years of adjustment policies and reforms, the indicators that refer to the efficiency of the goods and labour markets, as well as to the functioning of institutions, remain particularly unfavourable.<sup>20</sup> The same applies to the operation of free competition and the market economy. There are still many obstacles to competition, either because of high concentration in certain markets or because of over-regulation and/or ineffective operation by antitrust authorities.

Figure 6 illustrates the most problematic factors for doing business and engaging in foreign investment in Greece, according to the World Economic Forum report. As far as investors are concerned, the biggest problem of the Greek economy is policy instability, followed by high tax rates and an inefficient government bureaucracy. It

should be noted that the first two problematic factors did not exist prior to the crisis.

Moreover, regarding corruption – which increases public spending, enhances the grey economy and discourages investment – Transparency International's 2015 score for Greece is the same as the 2006 value.<sup>21</sup> In other words, one of the most important root causes of the Greek crisis showed no improvement at all, despite all the efforts made as part of the adjustment policies.

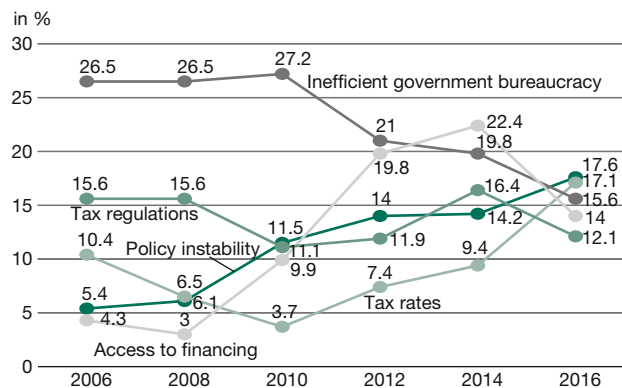
From the above, we can conclude that institutional inefficiency, over-regulation, bureaucracy, corruption, market rigidity and high taxation are the main deterrents to investing in Greece. After the outbreak of the crisis, reduced access to financing and political and macroeconomic instability were added to these factors. Hence, the adjustment policy not only failed to improve the key determinants of investment but, on the contrary, preserved already negative indicators at very high levels. Potential investors were thus faced with further counter-incentives at a time when – because of the recession and reduced access to finance – major investments could mainly be financed only with foreign capital. Other countries that were caught in the EU crisis managed to attract foreign direct investment in order to support their recoveries and exit the surveillance programmes.

<sup>19</sup> World Economic Forum, op. cit., pp. 190-191.

<sup>20</sup> OECD: OECD Competition Assessment Reviews: Greece 2017, Paris 2017, OECD Publishing.

<sup>21</sup> Transparency International: Corruption Perceptions Index 2015, 2016, available at <https://www.transparency.org/cpi2015/>.

Figure 6  
Most problematic factors for doing business in Greece, 2006-16



Source: World Economic Forum, Executive Opinion Survey 2016.

### The chronic structural weaknesses of public finances

The derailment of Greece's public finances and the debt crisis are symptoms of a malaise of the Greek political and economic system, the underlying fiscal causes of which run even deeper. First of all, the political system has an inherent tendency to cave in to vested interests, such as labour unions, state-owned enterprises, state-subsidy-dependent private enterprises and other social groups.<sup>22</sup> Then there are the chronic problems regarding the organisation and operation of the tax collection mechanism, as well as the enforcement of tax law.<sup>23</sup> Over-regulation and the complexity of tax law, in conjunction with high tax rates, is another reason behind limited tax collection. From 1975 to 2016, for example, more than 250 tax bills were passed by the Greek Parliament, and almost 115,000 tax-related ministerial decisions were issued. These not only failed to improve the country's tax system but, on the contrary, rendered it even more opaque, ineffective and costly to administer.<sup>24</sup> Following the onset of the crisis and the subsequent deepening of the recession, the problem was compounded by the state's failure to collect verified direct and indirect taxes.<sup>25</sup> However, the build-up of public debt was mostly due to two deeper and interrelated causes, namely excessive spending and the loss of revenues. Both were targeted by adjustment policies from the very outset, so the question is whether these causes were effectively dealt with.

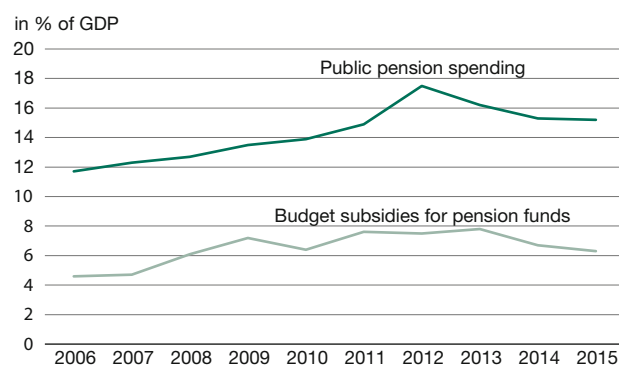
22 T. Michas: Putting politics above markets: historical background to the Greek debt crisis, Cato Working Paper, Cato Institute, 2011, available at <https://object.cato.org/sites/cato.org/files/pubs/pdf/Working-Paper-5.pdf>.

23 IMF: Greece Selected Issues, in: IMF Country Report No. 17/41, Washington DC 2017, International Monetary Fund.

24 Ernst & Young: Tax Evasion in Greece, study on behalf of diaNEOsis, Juny 2016, available (in Greek) at [http://www.dianeosis.org/wp-content/uploads/2016/06/tex\\_evason\\_version\\_240616\\_2.pdf](http://www.dianeosis.org/wp-content/uploads/2016/06/tex_evason_version_240616_2.pdf).

25 Ibid., pp. 76-82.

Figure 7  
Public pension spending and budget subsidies, Greece, 2006-15



Sources: Eurostat; Hellenic Ministry of Finance; own calculations.

The first cause is the high expenditure on social security and, in particular, pensions.<sup>26</sup> There are a series of problems that plague the social security system, such as contribution evasion, undeclared work, unemployment, the comparatively large number of pensioners and, above all, the high replacement ratio, i.e. the percentage of workers' earnings that is paid in the form of a pension after retirement, where Greece was ranked first among EU member states in 2009. Consequently, Greek pension funds have traditionally run deficits, with the shortfalls funded by the government budget.<sup>27</sup> This led to the significant increase of total public expenditure on pensions (i.e. pensions paid to government employees and subsidies paid to pension funds), as shown in Figure 7. However, the greatest problem of Greece's social security system is the funding of pension fund deficits through state subsidies.<sup>28</sup> In 2000 this subsidy stood at €4.8 billion (3.3% of GDP), while in 2009 it had risen to €17 billion (7.2% of GDP), becoming a permanent cause of budget deficits and public debt accumulation.

In the period 2000-2009, pension funds were subsidised with €98 billion from the government budget, an amount that accounts for 61% of the increase in public debt during the same period, turning the pension issue into the primary cause of the 2009-10 crisis. From 2000 to 2016, the subsidies paid to pension funds amounted to €191 billion, i.e. 58% of the existing public debt at the end of 2016. After the launch of the adjustment programmes, there was an effort to reduce total pension spending, but it nonetheless

26 IMF, op. cit., p. 32.

27 P. Tinios: Towards a New Social Contract: Greek pensions halfway through adjustment, LSE Hellenic Observatory Policy Paper, 2016, available at <http://www.lse.ac.uk/europeanInstitute/research/hellenicObservatory/CMS%20pdf/Publications/Greek-Pension-Publication-by-Platon-Tinios.pdf>.

28 IMF, op. cit., p. 35.



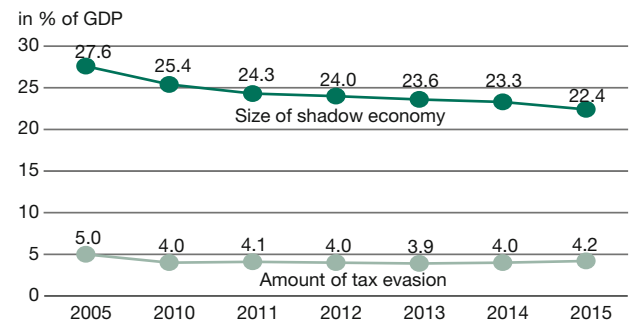
remains very high in comparison to other OECD countries. Thus, in 2014 total spending on pensions accounted for 15.3% of Greek GDP, while the OECD country average stood at 7.9%. The annual state subsidy paid to Greek pension funds also remains very high. Despite a slight reduction in 2013, the 2017 government budget provides for an increase in state subsidies equal to nine per cent of GDP.<sup>29</sup>

High public spending on pensions not only imposes a burden on the government budget by making it difficult to finance the deficits and service the debt. It also has major growth effects, as it distorts the distribution of resources in favour of consumption and against investment and economic growth. Moreover, by increasing social security contributions and taxes in order to finance pension fund deficits, the government reduces workers' disposable incomes and, consequently, their demand, savings and willingness to work. Concurrently, this incentivises entry into the informal economy, which results in lower fiscal contributions and promotes tax evasion – as well as the emigration of young people. Therefore, radical pension system reform is a main prerequisite for the country's exit from the recessionary vicious circle.

The second deep-rooted cause of government over-indebtedness is related to the shadow economy and tax evasion.<sup>30</sup> Cracking down on tax evasion has been a stated goal of every Greek government and one of the key aims of the adjustment policies. Tax evasion not only causes revenue loss for the government and the pension funds. Economic sectors that offer significant potential for tax evasion, such as freelance professions and small and medium-sized enterprises, especially in the consumer services industry, attract economic resources, thus reducing the economy's capacity and enhancing its introversion.<sup>31</sup> Moreover, tax evasion creates an uneven playing field, given that tax evaders enjoy a competitive advantage in regard to the final cost and the price of their goods and services. This could prompt legitimate businesses to follow suit, as those that pay their taxes are threatened with being driven out of the market.

The complete measurement of the grey economy and tax evasion is an almost impossible task, and thus, all relevant studies stress that they constitute an approximation of the phenomenon.<sup>32</sup> Figure 8 shows the development of the grey economy

**Figure 8**  
Shadow economy and tax evasion in Greece, 2005-15



Source: F. Schneider: Tax Evasion, Shadow Economy and Corruption in Greece and Other OECD Countries: Some Empirical Facts, speech at 11th Athens Tax Forum, 20 April 2015, available at <http://www.amcham.gr/wpcontent/uploads/2015/taxspeeches/friedrich%20schneider.pdf>.

and tax evasion in Greece before and after the crisis. We can see that these phenomena were slightly contained after 2010.

Nonetheless, Greece still has one of the largest grey economies and one of the highest tax evasion rates in the EU. According to a recent survey,<sup>33</sup> tax evasion is estimated to amount to six to nine per cent of GDP and leads to an annual state revenue loss of €16 billion. This lost revenue would be enough to cover the public sector's payroll cost (€15 billion) or the annual debt servicing requirements. As a result, the efforts to increase government and pension fund revenues impose an excessive burden on those businesses and workers that are unable to under-report their incomes.

Greece's shadow economy and high tax evasion are due to a very wide range of factors, including over-regulation and the complexity of the tax system, legal uncertainty, high tax rates, the lack of political will for dealing with this phenomenon, the insufficient technical and organisational infrastructure of the tax administration, bureaucracy, the extremely large number of self-employed individuals and very small enterprises, and cultural factors, such as citizens' attitudes towards the state and tax morale.<sup>34</sup>

Based on these factors, it is easy to conclude that – despite efforts – tax evasion has not been dealt with and, therefore, the solution to Greece's fiscal problem requires the implementation of a coherent strategy. This strategy must emphasise measures aimed at remedying the causes, such as the reduction of tax rates, the use of plastic money and electronic invoicing, the tightening of tax audits and the establishment of harsher penalties, the upgrading of tax collection technology and the streamlining of the operation of the tax authorities, the proper staffing of the tax authorities,

29 IMF, op. cit., p. 42.

30 A. Bitzenis, V. Vlachos, F. Schneider: An exploration of the Greek shadow economy: Can its transfer into the official economy provide economic relief amid the crisis?, in: *Journal of Economic Issues*, Vol. 50, No. 1, 2016, pp. 165-196.

31 Ernst & Young, op. cit., pp. 59-69.

32 F. Schneider: Tax Evasion, Shadow Economy and Corruption in Greece and Other OECD Countries: Some Empirical Facts, speech at 11th Athens Tax Forum, 20 April 2015, available at <http://www.amcham.gr/wpcontent/uploads/2015/taxspeeches/friedrich%20schneider.pdf>.

33 Ernst & Young, op. cit., p. 79.

34 Ibid., pp. 36-53.

the creation of a stable and simplified tax system, and the enhancement of the tax conscience in the Greek people.

### Conclusions

This analysis was prompted by the prolonged recession in Greece, which has been longer and deeper than anticipated. There is no doubt that the fiscal austerity policy and income reductions, together with political uncertainty and delays in privatisation, were major causes of the recession. The adjustment policies implemented to date have primarily focused on fiscal consolidation and internal devaluation and, in the long term, on a series of institutional and organisational reforms of the state and the economy. From the outset, the economic policy mix that is implemented through the memorandums focused on treating the symptoms of the crisis instead of decisively dealing with its root causes. These causes include the structural weaknesses of the Greek economy, such as its limited productive and innovative capacity, the predominance of traditional, lower knowledge- and technology-intensive sectors, the introversion of the production system, and the low percentage of exports, as well as the limited participation of Greek enterprises in international production and distribution chains. GDP formation was, for many decades, mainly based on domestic consumption, while neglecting investment. Moreover, a series of flaws in the organisation and operation of the political and economic system, such as cli-

entelism, corruption, bureaucracy, over-regulation, market rigidity, reduced domestic competition, legislative complexity and legal uncertainty, the instability and complexity of the tax system, and other obstacles to doing business were major impediments to investment, entrepreneurship and competitiveness long before the 2009 crisis. Finally, the deterioration of public finances and the resulting over-indebtedness were primarily due to two chronic illnesses of the public economy, namely the excessive spending on and subsidisation of the pension system, which in turn led to high tax evasion.

Despite some marginal improvements, most of these structural and systemic weaknesses, which constituted the deeper causes of the crisis, are still present, preventing the country from exiting the recession and entering a new era of modern institutions with a competitive economy. Therefore, Greece's adjustment policies will not help the country enter a path of sustainable growth unless they solve the chronic weaknesses of the Greek economy and public administration. Simply persisting with macroeconomic adjustment policies – which are indeed necessary – is not enough to permanently solve the Greek problem. The country needs a strong structural policy that will help it acquire a new production model based on extroversion, innovation and sound entrepreneurship, as well as a domestic economic system with functioning markets, stable and transparent institutions, and an effective public administration.