AUSTERITY IN PERPETUITY:
GIVING GREECE SOME BREATHING SPACE

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Introduction

After the 2008 financial crisis, the world economy faced an enormous challenge, the severity of which had not been matched since the Great Depression. However, this time round, the economic policies that were followed around the world were aimed at stimulating the economy which was contrary to the austerity policies that were followed during the Great Depression (Roeger& Veld, 2012). A year later, things got worse for five European countries (Portugal, Italy, Spain, Ireland and Greece) as they were under the additional pressure of the nascent Sovereign debt crisis. Severe austerity measures had to be implemented in all five countries in order to put their economies on a trajectory that would converge to sustainability in the mid-term (Lane, 2012). After many years of economic hardships, the Greek people, who were at the epicenter of the sovereign debt crisis, demonstrated their desire for change by electing a new prime minister.

On the 7th of July 2019, the Greek people elected Kyriakos Mitsotakis, president of the liberal-conservative party "New Democracy", as their PM. His party had not been in power since they lost the elections of 2015, which was also when he became the party's president. A focal takeaway from his recent electoral campaign was that he would primarily focus on *boosting the economy* and restoring stability such that the country can have prosperity in the future without having to rely on borrowing from other countries. Although he was careful in making "campaign-like" pledges, some of the promises made were tax cuts in corporate, property and income, a raise in the minimum wage and public investments.

The main focus of this article will be to critically evaluate (from an economic perspective), through a literature review, how *realistic* these policies are and how *effective* they will be at boosting the economy. In the first section, a general overview of the current state of the Greek economy will be given. Then, in section 2, there will be a critical evaluation of how realistic the promised policies are. Finally, in section 3 their effectiveness will be assessed, which will be followed by a brief summary of the article.

Section I: Current Situation in Greece

Overall, there are several signs that the economy is starting to stabilize from the crisis ("Greece: Economy improves, key reforms still needed", 2019). However, despite those general signs, it is useful to compare how Greece performs relative to similar countries. In this section a comparison of the general trend in debt, growth, investments, exports and unemployment will be made against the rest of Europe. The section will be concluded with an analysis of the burden imposed by the mandatory annual debt-repayments.

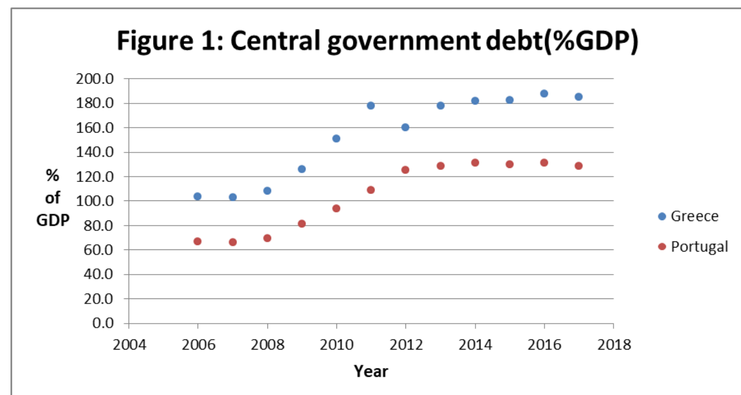


Figure 1:Central government debt for Greece and Portugal as a percentage of GDP. Data retrieved from IMF.

Portugal, who was also one of the five European countries trapped in the quagmire of the sovereign debt crisis (although it's debt peaked at 131.2% of GDP which is around 55% less than Greece as shown in *Figure 1*), has been showing stronger signs of recovery (IMF, "Central Government Debt", 2019). The two countries had relatively similar economies before the 2008 crisis (Galanos, Liapis, Rovolis& Thalassinos, 2013). It is worth noting that Greece had around 17% higher GDP per capita than Portugal, but by 2018 Portugal was ahead by approximately 13% (World Bank, 2019). A possible explanation is the difference in their annual **growth** in GDP per capita. For Greece the average annual growth between 2006 until 2018 was -1.2%, whereas for Portugal it was 0.6% with the European average being 1.0% (World Bank, 2019). Despite these demoralising facts, Greece has averaged an annual growth of 1.2% since 2014 and according to IMF it is expected to have positive growth in the next for years, which can be seen as a promising sign for the future.

In order to be able to see what the direction of the Greek economy will be in the near future, it can be useful to see the trends in gross capital formation. As Ali, Iftikhar, Nisa and Umar (2016) find, gross fixed capital formation can influence the steady state level of GDP. This in turn can influence the growth rate of a country as predicted by the Ramsey-Cass-Koopmans model. As illustrated in *Figure 2,* Greek annual **gross capital formation** (% of GDP) has been lower than the pre-crisis levels. For instance, investments (% of GDP) in 2018 were 50% less than they were in 2006. It can also be seen from the

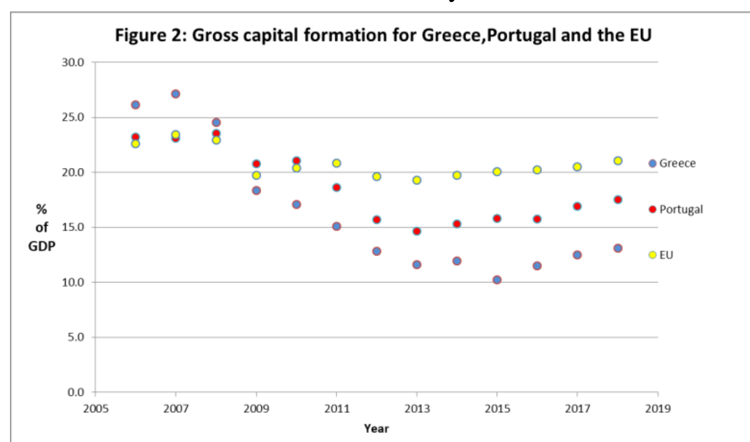


Figure 2: Gross capital formation (% of GDP) for Greece, Portugal and the EU between 2006 and 2018. Gross capital formation consists of consists of outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. Data retrieved from the World Bank.

graph that investments (% of GDP) in Portugal and even across all European countries were on average lower after the 2008 crisis than before, but to a smaller degree.

Similarly, **exports** (% of GDP) can also tell a lot about the state of a country's economy and its competitiveness with the rest of the world since they too influence the steady state level of GDP (Ali et al., 2016). Changes in trade balance can also have a direct effect on both the unemployment rate and the employment composition for different sectors of the economy (Deardorff, Hall, Sachs & Shatz, 1994). As depicted in *Figure 3,* Greek exports (% of GDP) are lower than the European average by 5%. However, this difference was at 16.5% in 2006, and despite the additional pressure of the sovereign debt crisis, the gap has shrunk. This certainly does not mean that Greece is rigorously catching up since the difference in the average GDP growth rates during this entire period was at 2.2% in favour of the EU countries (World Bank, 2019).

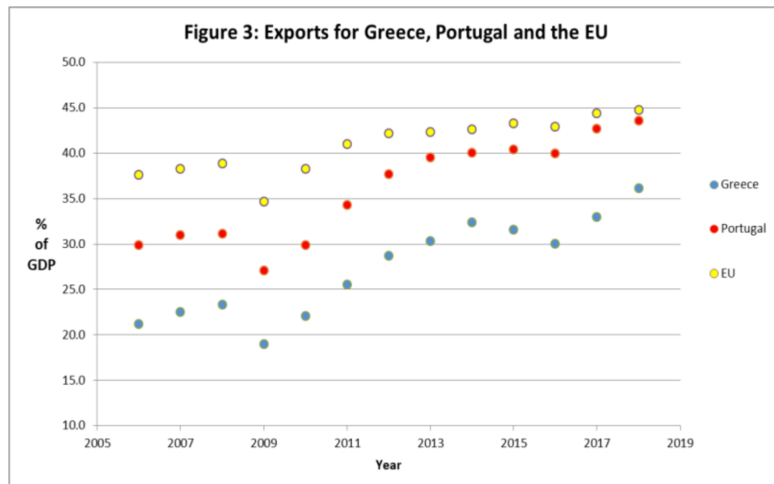


Figure 3: Exports (% of GDP) for Greece, Portugal and the EU between 2006 and 2018. The vertical axes have been rescaled for visual purposes to omit values below 10% since no observations were in that region. Data retrieved from the World Bank.

Another major issue that concerns Greek people is **unemployment**. As *figure 4* depicts, unemployment in Greece proliferated rapidly after 2009 and peaked at 27.5% in 2013. Despite being at similar levels with the EU during the financial crisis, the difference between them rose to 16.7%. It can also be seen that Portugal, which as explained previously is a good proxy to compare Greek performance, had an increase in unemployment but significantly smaller. It peaked at 16.2% in 2013 and it has recovered since then, reaching almost the current European average of 7.6%. It is important to note that unemployment statistics do not include people who are not actively looking for work (World Bank, 2019). Since unemployment rates have been very large in Greece for eight consecutive years, it is likely that a large proportion of the population are discouraged from actively searching for a job, which can cause an underestimation of the actual unemployment rate (Gregg, 1994; Beatty, Fothergill, Gore& Herrington, 1997).

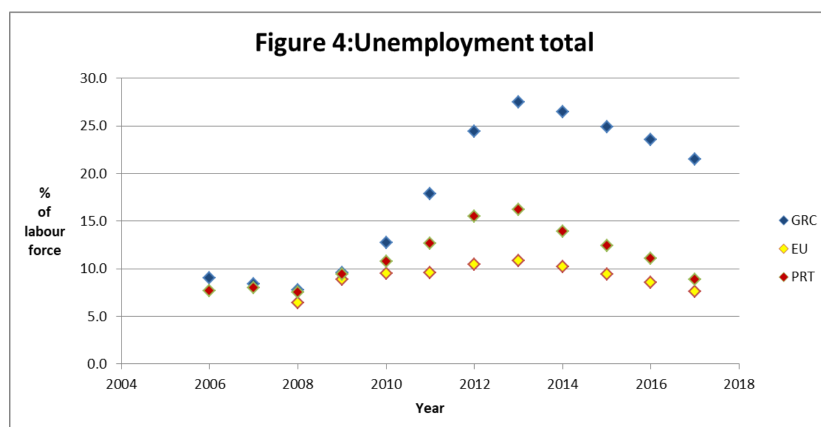


Figure 4: Unemployment total (% of total labour force) for Greece, Portugal and the EU average for 2006-2017. Data for the EU in 2006-2007 were unavailable. Data retrieved from the World Bank.

When looking into the Greek unemployment statistics in more detail, as in *Figure 5*, two remarks stand out. First, unemployment amongst the youth and people with advanced education has actually decreased since the financial crisis. This means that kids are able to stay in school more, instead of trying to find a basic job to support their families. Also, it implies that people who are qualified (from an educational perspective) are able to find a job despite the difficult state of the economy. Secondly, unemployment amongst people with intermediate and basic education has increased a lot since the pre-crisis period. This is a very important piece of information for policy makers since these people are effectively looking for *minimum-wage jobs.*

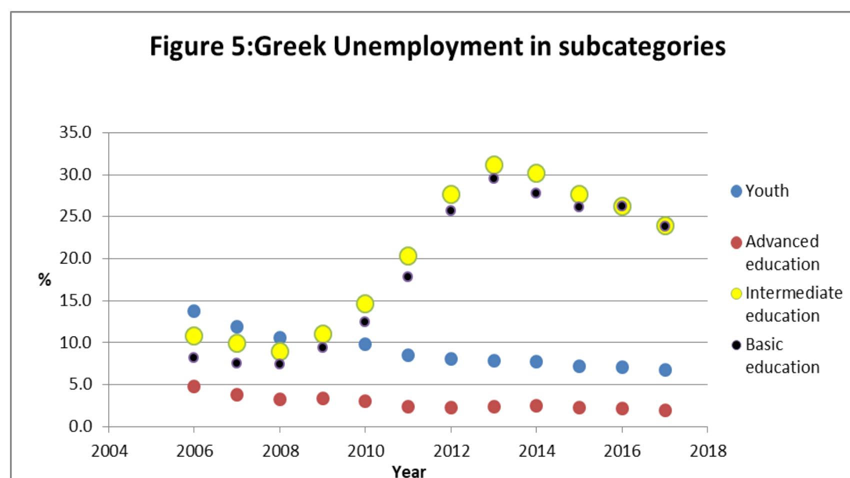


Figure 5: Unemployment in Greece amongst 4 subgroups (youth, people with advanced, intermediate and basic education) for 2006-2017. The subgroup "Youth" includes the labour force of ages 15-24. Each of the three educational categories is in accordance with the International Standard Classification of Education 2011 (ISCED 2011). The vertical axis shows the unemployment percentage from the total labour force with the respective subgroup characteristic. Data retrieved from the World Bank.

Finally, **debt repayment** is an issue that concerns primarily both the lenders of Greece and its potential investors. The amortization has been structured in a way that is both sustainable for Greece and fair to the lenders. According to the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF), who are two of the primary lenders for Greece and hold €204 billion (of the €394.4bn total as of March 2019), the amortization of the debt is scheduled to continue until 2070. The annual repayment amounts will vary from year to year and are expected to be around €1.8bn for the next 2023 to 2033 and will then increase slowly until they reach their peak of €7.4bn in 2060.

Greece had to make a lot of commitments to its creditors which functioned as repayment assurances. One amongst them was to have a primary budget surplus of 3.5% of GDP every year between 2018 and 2022. The commitment on the 3.5% target was part of a debt relief deal which was agreed upon in 2018 by Greece and its creditors. The deal also includes a 2.2% average surplus target until 2060 which effectively means *austerity in perpetuity*. It should be noted that primary budget surplus is different from total budget surplus (also referred to as overall balance) in that it excludes interest payments on outstanding debt. For instance, in 2018 Greece had a primary surplus of 3.76% which translated to 1.1% of total budget surplus due to the large interest payments on loans. This effectively means that Greece is required to save more than it spends, even after satisfying the agreed annual loan payments. This commitment is very restrictive for a policy maker especially when looking for ways to boost the economy.

Section 2: Evaluation of realism of promised policies.

Crucial promised policies (not a complete list of the electoral manifesto):

- Increase the minimum wage from €683.76 to €730 within 3 years
- Reduction of the corporation tax from 28% to 20% within 2 years.
- The creation of 43000 new jobs each year aimed at improving the infrastructure.
- Investments between €54-64 billion in various sectors of the economy (exact timing has not been specified as of July 10th 2019).

First of all, the increase in the minimum wage is realistic according to the real GDP growth projections by the IMF. The PM promised that the minimum wage will grow at an annual rate *twice* as fast as the growth of the economy. That will not be necessary, assuming that the IMF growth predictions are accurate, since the minimum wage can easily reach 727 by the end of 2021 if it simply follows the growth in *real* GDP (excluding inflation which is predicted to be at an average of 1.4% in the next 3 years). Including inflation to the growth in minimum wage can make it even easier to reach the target level faster. After some calculations it is expected to reach €731.62 by 2019 simply by increasing it by a rate double that of the nominal GDP growth, as suggested by the PM in interviews.

It is an undeniable fact that the commitment of 3.5% primary surplus is very restrictive for a policy-maker especially when looking for ways to boost the economy. One solution that could work in theory would be to increase taxes from some areas of the economy in order to reduce taxes in the desired ones. However, such novel options have not been proposed by the PM and it is probable that they have been exhausted after the laborious scrutiny of the Greek economy by the IMF. In addition, further increasing taxes is no longer a sustainable option. Kaplanoglou and Rapanos (2012 & 2018) explain the stagnation and detrimental long-lasting social consequences that have been caused by the large rise in direct and indirect taxes since the sovereign debt crisis.

Another issue is the shadow economy which is one of the largest in Europe. Decreasing the size of the shadow economy can have a significant impact on the tax revenue due its size (Katsios, 2014). However, it is definitely not a simple and rigorous process. Bird, Torgler and Vazquez (2006) find that a more legitimate and responsive state, which can be achieved by improving the political and economic institutions of a country, is necessary for a more adequate level of tax effort. Schneider and Torgler (2009) also highlight the importance of a well-functioning, legitimate government with a sound law system as preconditions for higher levels of tax-morale and a smaller size the shadow economy.

The only immediate possible solution, which seems to be the cornerstone of Mitsotakis's plan, is to re-negotiate with the lenders about the 3.5% target and about relaxing the degree of austerity in the economy. The mandate given by the recent electoral win (39.85% of votes against 31.5% for the runner up) might be a favorable "bargaining chip" for these negotiations but it only time will tell what the outcome of the negotiations will be. A new agreement could be to reduce the size of the annual amortization payments and relax the 3.5% commitment. This would be beneficial for Greece because of the growth and inflation that will be accumulating. Inflation increases the tax revenue and effectively makes the real cost of debt decrease (as long as the debt was issued in

nominal terms, as is the case with Greece) and growth means that the debt payments will be a smaller part of the whole economy. However, simply because of the concept of the present value of money, this would be unfair and unfavourable for the lenders.

Section 3- Evaluation of effectiveness of promised policies

In order to examine how effective the promised policies will be, it is first necessary to posit that the PM will be successful in the negotiations, as explained in the previous paragraph. Then, given that the austerity commitments have been relaxed to levels that allow the fulfillment of some of the promises made in his electoral campaign, a critical evaluation of their potential efficacy can be made.

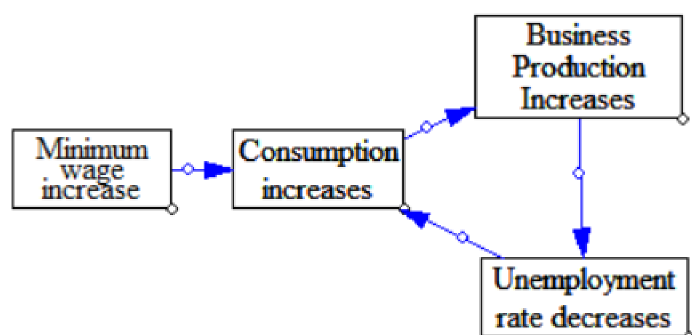
3.1 Minimum wage

First of all, the change in the minimum wage is going to have a significant effect in the Greek economy due to the size of the unemployed labour force with basic and intermediate education *(Figure 5).* These people are probably looking for jobs that offer the minimum wage and if that minimum is increased, it will be harder for them to find employment according to standard economic theory.

However, as Card and Krueger (1994) find, a rise in minimum wage can have no effect, or even a small positive effect on employment, despite the standard predictions of economic theory. Neumark and Wascher (2000) raised some objections about the methodology used in their paper and instead find the opposite conclusion. Despite that, Card and Krueger (2000) replied in another paper by proving the robustness of their results and proposing possible explanations why different results emerged.

Therefore, increasing the minimum wage can actually have a net increase in welfare and give a boost in the economy instead of reducing the profits of businesses and increasing unemployment. A feedback loop can emerge were people will be able to consume more, and then businesses will want to produce more to capture higher profits caused by the larger demand. This can then lead to an increase in employment which will cause the cycle to repeat *(Figure 6).* Despite that, it is difficult to predict the exact outcome of such a policy because of the large unemployment rates among people looking for jobs with minimum wage. Such a situation is completely different from the one analysed in research papers presented previously and might thus yield unexpected results. If the minimum wage is increased slowly, it is unlikely that unemployment will be affected. However, this will also mean that the increase in the purchasing power of individuals will not increase as much as it would with a rapid increase in the minimum wage. This can lead to an adverse effect as consumption might not increase significantly and thus the feedback loop might not emerge.

Figure 6: Feedback Loop from minimum wage increase



3.2 Corporation tax

A reduction of the corporation tax by 8% can have a large effect on the tax revenue of the country. The obvious benefit of such a policy will be an increase in corporations' profits. As standard economic theory predicts, corporations will be more competitive on the international market and therefore investments will probably increase and unemployment will go down.

However, the cost of such a policy will probably outweigh the benefits, at least for the present state of the economy. According to Davis, Haltiwanger and Schuh (1996), larger employers promote job quality and job creation more than smaller employers due to the larger net job creation rate *(=gross job creation - gross job destruction).* The policy implication of this finding is that it might be preferable to first allocate part of the budget on the tax reduction of larger corporations and then, as the economy is getting better, gradually reduce the tax for smaller corporations also.

Finally, this policy can be beneficial without even being implemented. Simply the fact that it is part of the manifesto shows that the PM wants to boost the economy and help the business sector flourish. This creates an image of a more stable and prosperous environment which can attract investors. Evidence of such trends were quickly seen on the day right after the election as bond yields fell quickly to new all-time lows (Furness, 2019). Altavilla, Giannone and Lenza (2014) find that announcements of Outright Monetary Transaction (OMT) had a significant effect on the yields of the bond market in the period after the financial crisis. Furthermore, Goldberg and Leonard (2003) also find that economic announcements have a significant effect on bond yields in Germany and the U.S. These results can explain the recent trend in Greek bond yields and could also mean that simply because of the outcome of the election, Greek businesses will find it easier to invest which can help the state of the economy.

3.3 Job creation & public investments

It is certain that by investing €54 billion in the public and creating many new, some sectors in the economy will benefit significantly. However, these investments are very large for an economy with annual GDP of €200 billion. This means that the investments will be spread out over many years. Thus, it is very important to decide what sectors to invest in first.

Böwer, Michou and Ungerer (2014) find that a qualitative improvement of the Greek institutions until the European/OECD average would decrease the competitiveness gap between 54% and 78%. This would lead to increased investments and employment and thus a growth in the economy. In addition, Gwartney, Holcombe and Lawson (2004) find that institutional quality has a significant effect on economic growth by increasing the rate of investment and the productivity of resource use. They further estimate that a time lag of 5-10 years is necessary for the effects to be fully registered. Institutional quality is necessary since it encourages trust and justice which are both desired characteristics for attracting corporations in a country. The policy implication could be that it might be preferred to invest in policing, in the judiciary system and in decreasing bureaucracy instead of investing in infrastructure and in sectors like tourism or agriculture, as listed in the electoral manifesto of the ruling party.

When deciding where to invest first, it is crucial to take into consideration the cultural characteristics of Greek people. Ghemawat and Reiche (2011) find that Greece is the country with the highest *uncertainty avoidance* in the whole world. This effectively means that they prefer structure and predictability as opposed to an uncertain environment. This can partially explain the lack of investments and entrepreneurial activities as Greeks' risk aversion prevents them from engaging in such activities. The policy implication of this fact could be seen as an additional reason to invest in improving the quality of institutions. Having better institutions can help people pursue investment and business opportunities as they will be able to rely on the stability of the legal system and government regulations to be fair, operate quickly and respect their individual rights. Finally, Katsios (2014) highlights that high quality institutions can help to reduce the size of the shadow-economy. As explained in *section 2* the shadow economy is a principal problem for Greece as it obviates the collection of significant tax revenue.

Conclusion

In summary, this article finds that the promised policies made by the PM are realistic as long as he is successful in negotiating the reduction of the 3.5% primary surplus target which was agreed by the previous government. If such negotiations prove to be unyielding, there is little or no room to in the government budget to implement the desired policies.

As for the evaluation of some of the proposed policies this article finds that it would be beneficial for the economy to invest and create jobs targeted at improving the quality of the institutions instead of infrastructure and other sectors proposed by the PM. As explained in more detail in section 3, better institutions can increase investments, welfare and tax revenue significantly. Also, the article suggests that the reduction of the corporation tax should not be prioritized, as the costs of such a policy might outweigh the benefits, at least for the present state of the economy. Furthermore, it is difficult to predict what the effect of increasing the minimum wage will be on unemployment due to the large unemployment rates amongst people looking for minimum-wage jobs. However, if it is decided that the increase will be worth the cost, there is no need to increase it with a rate double that of growth as proposed by the PM. The promised level can be reached within the 3 year target by simply following the path of real GDP growth. The decision depends on what the budget allows and on whether an immediate increase in the purchasing power of individuals is needed.

Finally, even if the government budget does not allow some of the policies to be implemented immediately, the economy is likely to benefit either way because of the signal that was given by the PM about the importance of growth to the current government.

Further research is needed in evaluating the rest of the policy promises and especially the ones concerning the reduction in the VAT and both property and income taxes. Furthermore, additional research is needed in estimating the effects of an increase in minimum wage on unemployment in developed countries with high unemployment rates. This could be very useful not only for Greece, but also for developing countries in a few years when their institutions will reach a level that can enforce such measures.

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