

Theodore Pelagidis
University of Piraeus and
London School of Economics, Hellenic Observatory

Greece's sudden faltering economy: The paradox of falling competitiveness and weak institutions in a high GDP growth rate context (1995-2008)¹

Abstract

In this paper, we deal with some pieces of evidence that are needed to explain the paradox of rapid GDP growth in the face of the dismal competitiveness of the Greek economy during 1995-2008. We show how Greece's economy structural weaknesses have hit domestic economy and we investigate their impact on the current turmoil of the economy. We show that the previous favorable global economic environment acted as a locomotive to domestic growth, and now that it is gone, structural problems of low competitiveness and a ballooning public deficit and debt, have come to the surface. We offer a specific explanation of the current unfortunate state of the economy and we suggest avenues of necessary reforms to overcome it.

Keywords: Macroeconomy and Institutions, Competitiveness, The Greek Economy
Jel codes: D020, E020, E300, E660

1. Introduction

Looking at Greece's economy today, as the country is at the epicentre of turmoil nothing recall the relatively recent prosperous past any more. Since the mid 90's, Greece's economy enjoyed an average growth rate of 4% (Figure 1), which let the country converge, more or less, with the eurozone standards of living. But despite that, many structural weaknesses continued to prevail if not deteriorate. During the last 15 years or so, Greece substantially succeeded in improving the, let me say, the 'private standard of living' but it remained behind in the organization of its society, of its economic institutions, of the provision of public goods to the citizens. So, when the global economic crisis hit, all the mess behind the glittering and superficial 'nominal growth' came to the surface. So, this is how very briefly Greece suddenly became, if not the black sheep, the spoilt child of Europe.

To find a way out of this mess we need first to understand Greece's economy basic flaws, the distortions, the injustices, the bad incentives in our institutions, all that dominate today our economy and, then, find out the crucial link, the link of cardinal importance, the link that could bring a wave and a domino of progressive reforms, that is, reforms for the many.

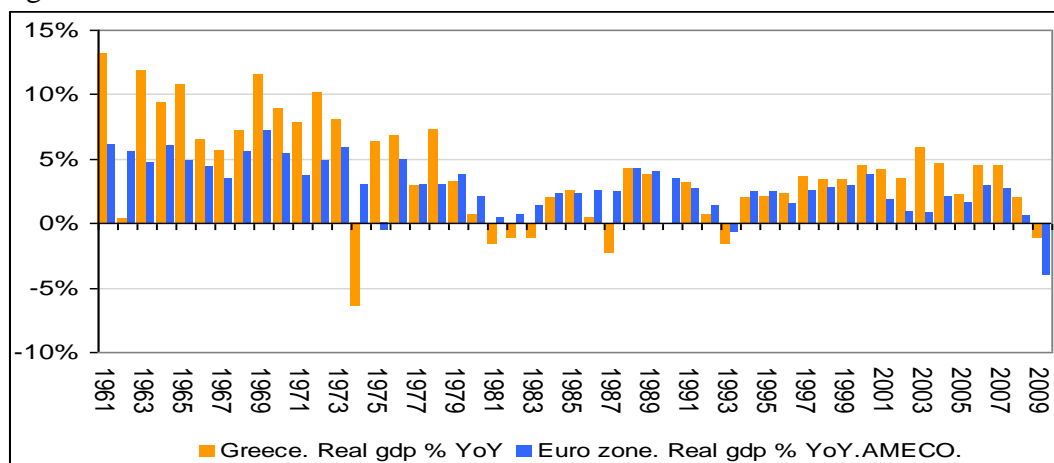
Let us first, thus, embark into the factors as well as the features of the prosperous past, a past that, as I will argue below, it contained the seeds of the current crisis or, for others, our decay.

¹ The paper draws from my book (co-authored with M. Mitsopoulos) on *Greece's Economy Paradox*, to be published in MacMillan/Palgrave in 2010/11. The paper presented in the LSE/HO seminar, on February 9th and has benefited from comments and suggestions from the audience, especially from J.Spraos and V.Monastiriotis. The usual disclaimer applies.

2. The engines of growth, 1995-2008

In Greece, certain positive developments led to the strong growth rates performance observed since the mid-90s and up to 2008. Figure 1 shows how Greece clearly outperformed, since 1995-96, the benchmark euro zone economy. However, it is absolutely crucial to look at the factors of 'growth' to see why, at least in the great part, it was superficial, fragile, import oriented, not based on the improvement, the deepening or the expansion of domestic production.

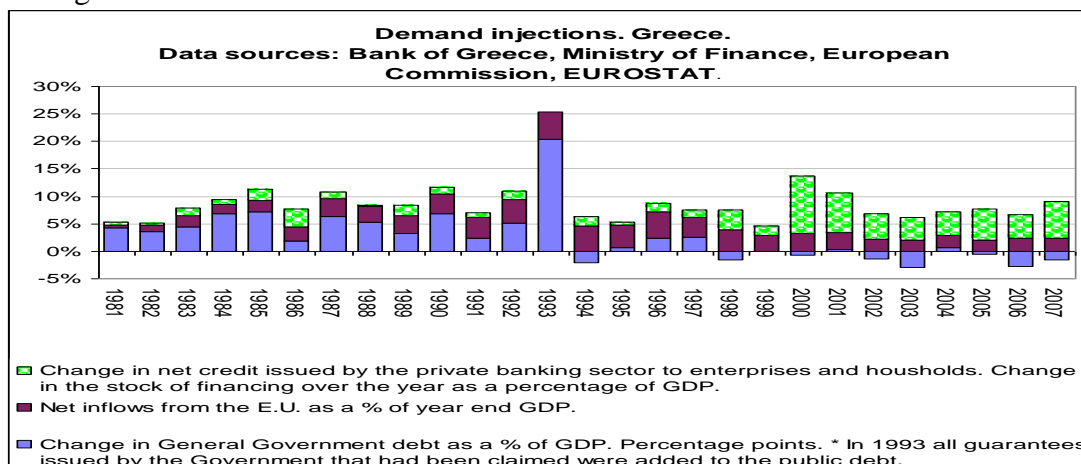
Figure 1



These developments include, primarily,

1. The proper liberalization of the credit markets at the beginning of the 1990's that was completed by the end of the 1990's at which time it was coupled with entry to the European Monetary Union. Combined these two developments lead simultaneously to macroeconomic stabilization and a steady increase of private credit after 2000. It has also to be stressed that the expansion of private credit replaced after the beginning of the 90's the government deficit spending as the main way to finance the expansion of consumption in Greece, although we should always keep reservations for the relevant data. The most possible is that fiscal expansion reinforced private credit and private consumption expansion. As figure 2 shows, the impact of these developments

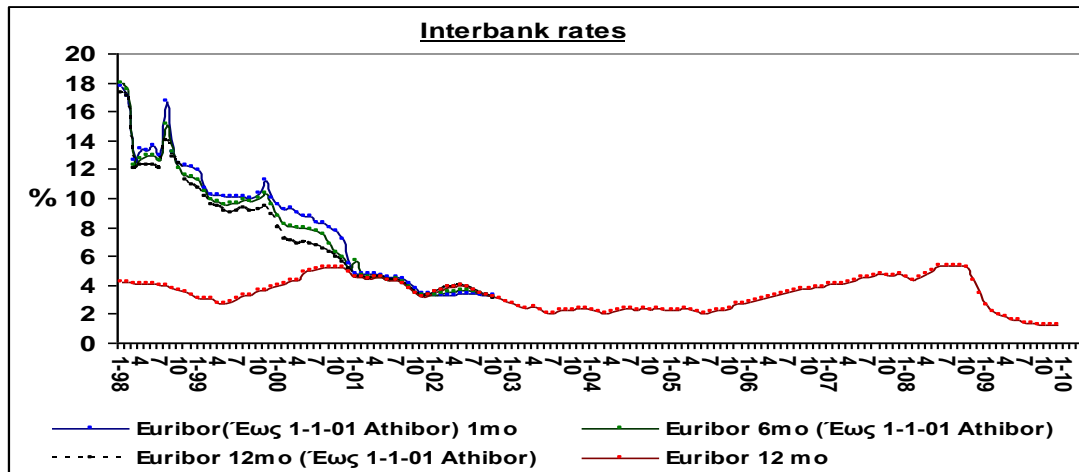
Figure 2



Source: Bank of Greece, Ministry of Finance, European Commission Budget and EUROSTAT.

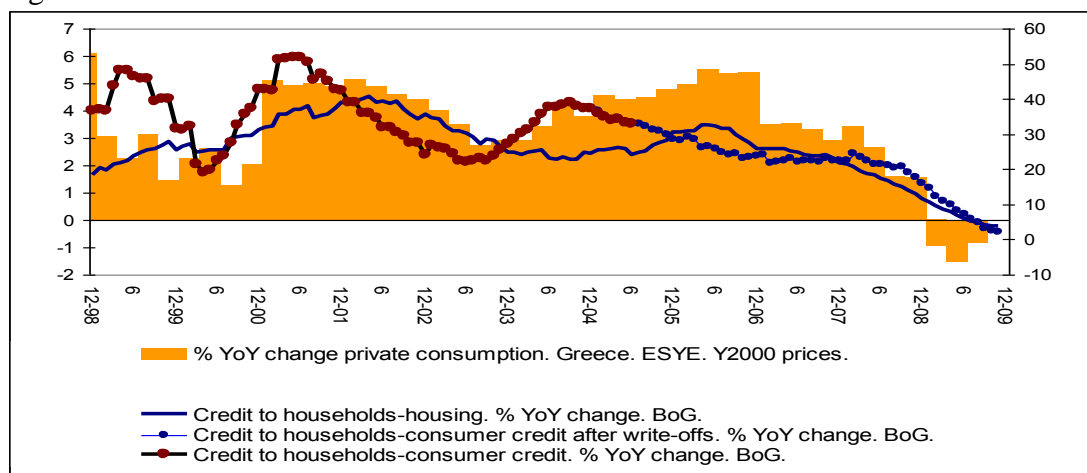
was important as a percentage of GDP for every year during a prolonged period that spans all the duration of Greece's strong performance. The contribution of the stabilization of the macroeconomic outlook of Greece in the wake of EMU accession towards the expansion of private credit was significant, as is shown by the rapid fall of interbank rates after 1998 (Figure 3),

Figure 3



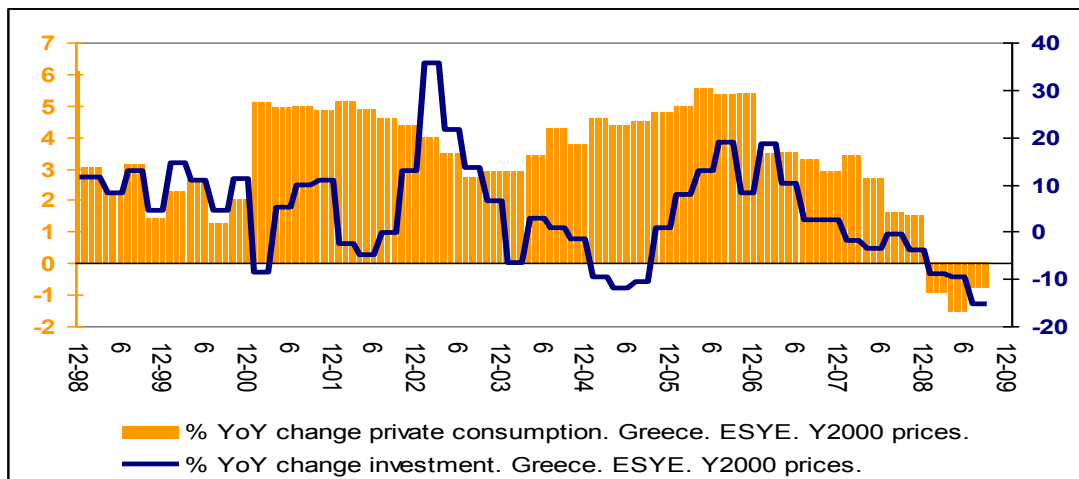
which reflect also the decline in the rates offered by commercial banks to households and businesses. (It also brought a significant fall of the inflation differential of Greece with respect to the euro zone average during the same period of time). It can be seen clearly how the expansion of credit to households fuelled the growth of private consumption during the past years (Figure 4), and only just the period preceding the completion of the infrastructure projects that were prepared to be ready for the 2004 Olympic games private consumption kept accelerating in spite of a lull in the explosive growth of private sector credit.

Figure 4



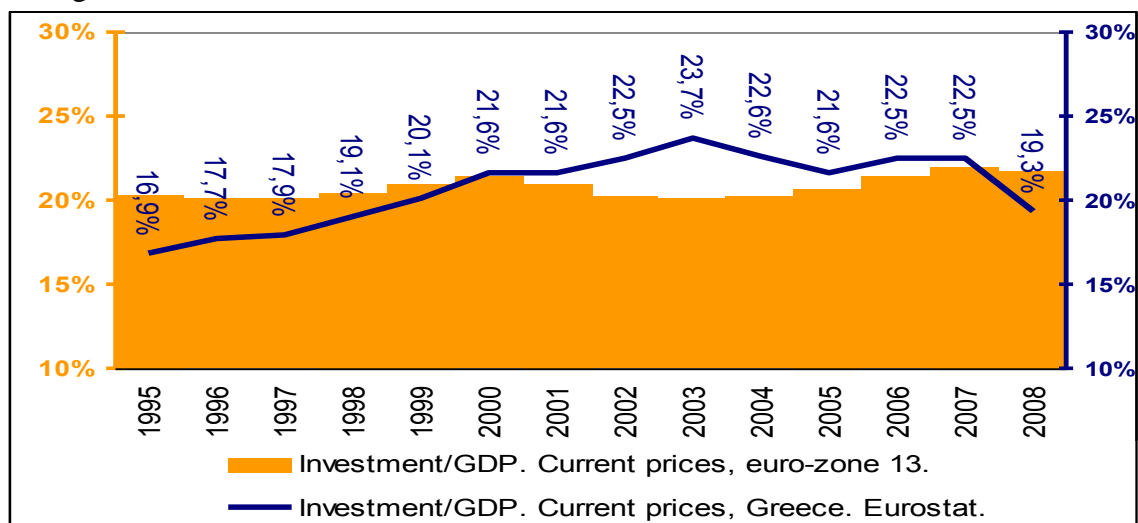
But this exception is easily explained by the peak in the investment growth rate during that time (figure 5).

Figure 5



2. The shipping and tourism industry. These secure significant annual revenue inflows of about 25% of GDP that are added to the domestic demand and help to mitigate the huge trade balance deficit.
3. The fiscal stimulus given by the 2004 Olympic Games nourished through public borrowing and that led to the improvement of certain key infrastructure facilities.

Figure 6



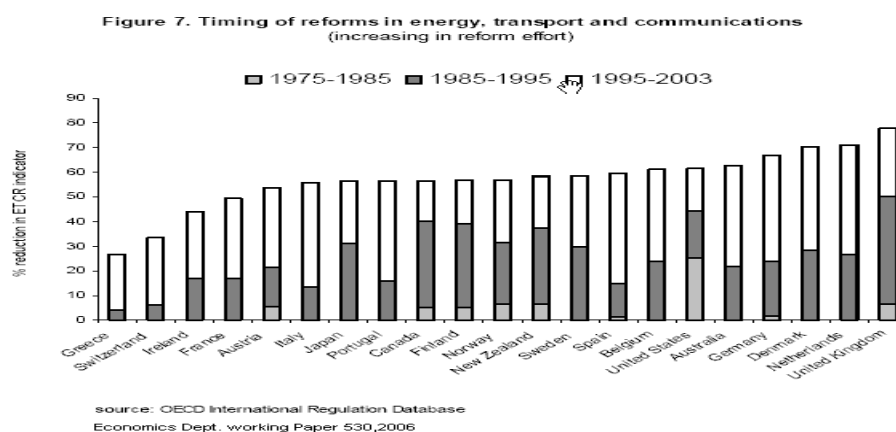
The rapid increase of new investment (Figure 6) also demonstrates the impact of the infrastructure investment that was largely financed by the EU structural funds. Still, the rush into EU-financed infrastructure investment did not only contribute to investments and consequently to the creation of new jobs, as in the end many of these projects, when finished, actively boosted –to an extent- the productivity of the Greek economy, especially in the area surrounding Athens which hosts about half the population and economic activity of the country.

The inflow of funds from the European Union (see back at Figure 2), within the context of the European Union structural funds and the Common Agricultural Policy, also contributed largely to the improvement of key productivity enhancing infrastructure facilities. Figure 2 also shows how the expansion of private credit

replaced after the beginning of the 90's the government deficit spending as the main way to finance the expansion of consumption in Greece. The impact of these developments was important as a percentage of GDP for every year during a prolonged period that spans all the duration of Greece's strong performance.

4. The improvement in the regulation of certain product markets (Figure 7), which has been reduced from a very high level, even though it still remains very high compared to other OECD countries according to Conway and Nicoletti (2006) (see graphs/figures 18, 19, 20, below). The OECD database accurately documents the documented improvement mainly to the liberalization of the telecommunications market at the beginning of the 1990's in particular. To a lesser extent that holds for transportation and energy.

Figure 7



3. The four facets of low competitiveness

However, at the same time, a wide range of factors persisted in contributing towards the poor performance in certain other aspects of the Greek economy. The poor performance regarding competitiveness, to name just the most important one, is not only documented by numerous databases and surveys by international organizations and researchers (see graph below), but also by the persistent deficit of the current account in double-digit numbers (as a % of GDP), the persisting positive differential with the euro zone average inflation and the unattractiveness of Greece to foreign direct investments that are practically zero (inflows minus outflows). Recent research by institutions like the OECD and the World Bank as well as a detailed presentation of numerous pieces of evidence indicate that the wide range of institutional weaknesses that prevail in Greece account, as a whole, for this dismal competitiveness performance. (I will come back to the institutional weaknesses after presenting the four facets of faltering economic performance).

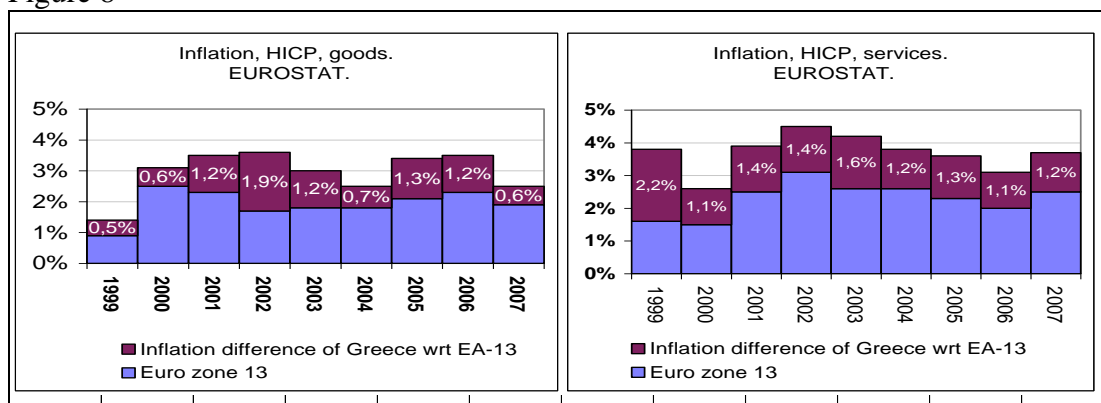
In spite of the impressive 4% average growth performance during 1995-2008, four pieces of information document that Greece's economy features certain severe weaknesses.

1. First, the persisting inflation differential with the euro zone,
2. second, the continuous excessive trade balance deficit,
3. third, we also add the low level of foreign direct investment that flows to Greece, proportionally to the size of the economy.

4. Last but not least, the consistent ranking of Greece by all competitiveness surveys² at a rank that is disproportionately low when compared to its per capita GDP

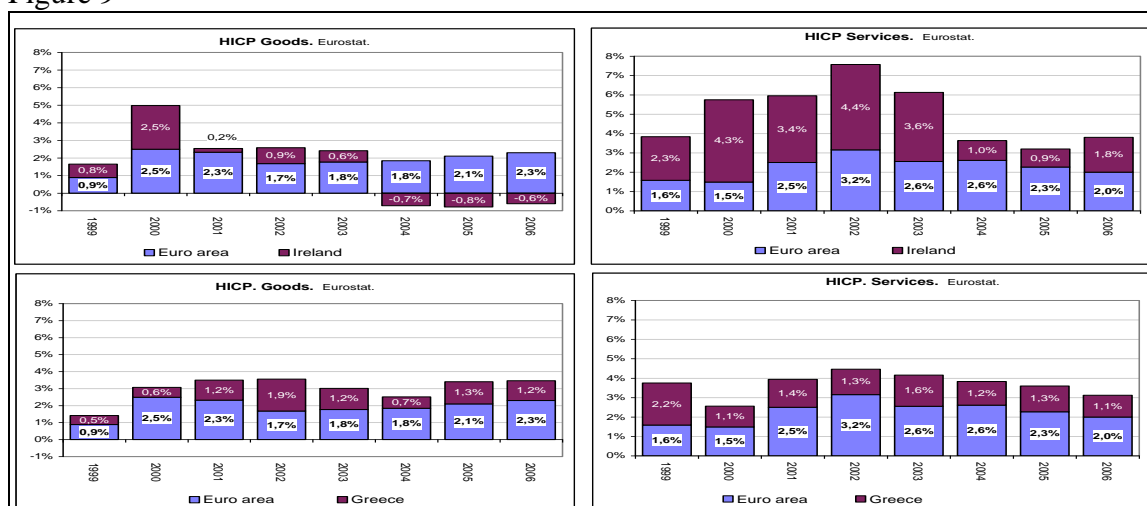
The interesting part about the inflation differential of Greece with the Euro zone (Figure 8) is not that it is there, something that many would explain with the Balassa-Samuelson effect because of the rapid growth rate of the country. It is that it seems to emerge both in the goods (tradable sector) and services (non-tradable) sub-indexes, something that initially seems to refute the Balassa-Samuelson argument.³

Figure 8



An expository comparison with Ireland, where the inflation of goods is much lower than the inflation of services, and that thus emerges as a textbook Balassa-Samuelson case, is most revealing (Figure 9).

Figure 9



The high inflation of Greece therefore seems to emerge as a result more of the demand increase, which is largely driven by the expansion of credit and the inflows from the EU-structural funds as well as from tourism and shipping industry or public borrowing, which is not matched by a similar increase in the domestic supply of

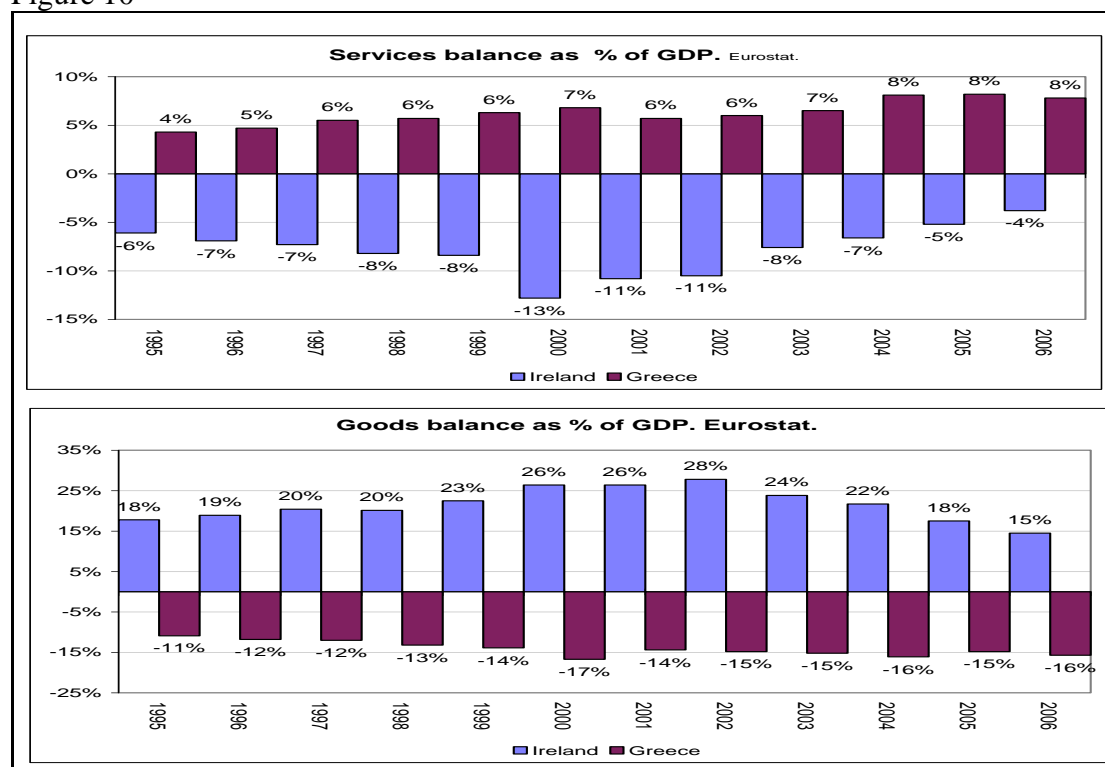
² Like the World Bank Doing Business and Governance Indicators, the World Economic Forum Competitiveness Index.

³ Although to a certain extent, tourism that constitutes a significant part of services, should be considered also as a 'tradable service'.

goods and services. And this is unlike the case of Ireland in which the surplus of the goods balance seems to finance a deficit in the services balance following again a pattern that fits well the standard predictions of the Balassa-Samuelson model.

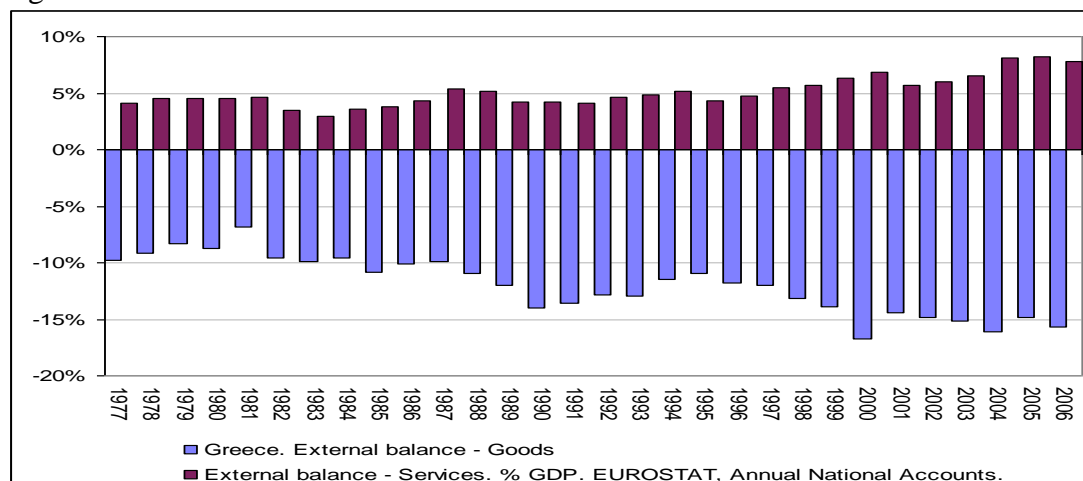
The second piece of evidence that supports this argument is the excessive –and increasing- deficit of the goods trade balance, as a percentage of GDP (Figure 10)

Figure 10



As a matter of fact the deficit is of a magnitude that has never been seen in any country without the subsequent emergence of serious consequences. In the case of Greece, the participation of the euro zone seems to have averted developments like the entrance into a spiral of high inflation and currency devaluations. As a result, the trade deficit in Greece can clearly demonstrate the existence of a serious discrepancy between the growth of domestic demand and the increase of the domestic supply of both goods and services. It should be stressed that in the case of non-tradable services, the inflation differential is sufficient to document the discrepancy between supply and demand, but the emergence of such a differential for goods as well suggests the peculiarity of the case of Greece. Therefore, the evidence at hand would make it more appropriate to label Greece as a unique case of 'quasi Balassa-Samuelson', where the inflow of the exporting sector is replaced by EU-transfers and domestic credit expansion, and the price level is pushed upwards both in the goods and in the services sector, which would actually be in line with the conclusions of recent research on the topic (Gibson 2007; Pelagidis and Toay, 2007). The increase of the goods deficit follows as a natural consequence in this case, as increases in demand are satisfied by competitive and available imported goods as there is no sufficient domestic supply of goods that can compete with the imports.

Figure 11

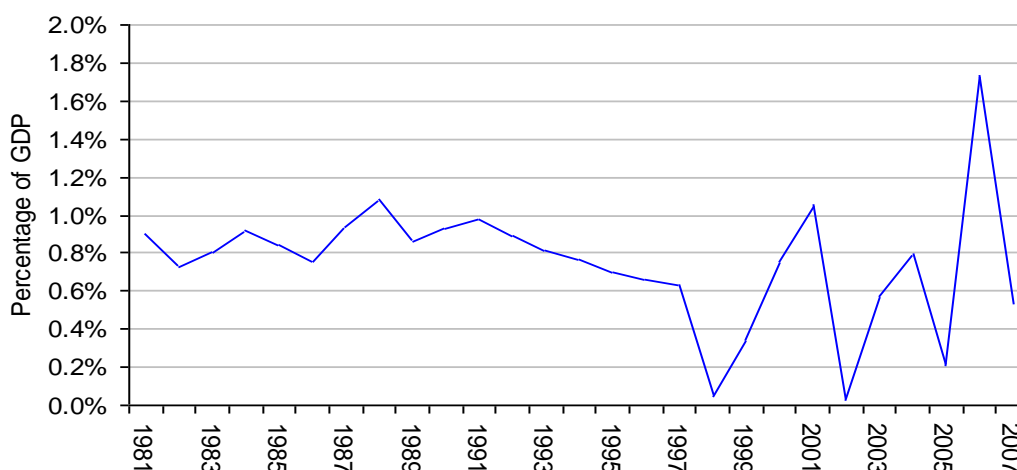


The third piece of evidence is the following: This persistent deterioration of the goods balance has been financed, besides from the surplus of the services account (Figure 11), through foreign inflows in both Greek government bonds as well as into the stocks of Greece companies, at least until the present financial turmoil made its appearance. However, it should be noted, rarely these inflows were FDIs. FDIs during the last three years were close to zero (\$0,9 bil. for 2006, \$-2,5 bil. for 2007 and \$1.3 bil. for 2008, according to the Bank of Greece).

Thus, according to Figure 12, FDI inward flows for Greece as a percentage of GDP are very low for almost all years something that is in line with the link between the attractiveness of the business environment and FDI (as described by authors such as Hajkova, Nicoletti, Vartia and Yoo (2007).

Figure 12

Direct Investment (FDI Inward)



Source: UNCTAD Globstat FDI Database.

The performance of the goods balance together with the inflation differential with the euro zone for tradable goods suggests also that the cost of importing and distributing these competitive imported goods is higher compared to the eurozone. Furthermore, it suggests that the imports remain competitive in the domestic market in spite of this

high cost of importing and distributing, which seems to be really damning for the competitiveness of the domestic supply of goods.

In spite of the mitigating effect of the surplus of the services balance, which is mainly driven by the performance of the shipping industry and tourism, the current account balance has remained for many years at a level, compared to GDP (around 15%), that in any other country would have been associated with serious consequences. For the two sectors that contribute to the services account surplus it should be noted that they are less affected by the regulatory environment of the Greek economy, either because they operate almost completely outside the Greek jurisdiction and administrative reality, for the case of shipping, or because they draw their competitive strength largely from the geographical attractiveness and the cultural heritage of Greece, as is the case for tourism.

Regarding the fourth piece of evidence, these aforementioned pieces of evidence are matched by the compelling case for the low competitiveness of the Greek economy that is documented by a number of surveys (Figure 13). The impressive part to note here is that a wide selection of different surveys, including those that measure governance and corruption, rank Greece in a roughly similar way even though they often use different methods that are either based on the evaluation of hard evidence, the responses to questionnaires or a combination of both these methods.

Figure 13

Competitiveness indexes

| Doing Business in 2009, World Bank. No of countries | Ease of Doing Business Rank. | World Economic Forum 2008 | GCI 2008-2009 rank | 2008 Corruption Perceptions Index Country Rank | Transparency International | UN | Rank per capita income in US \$ |
|---|------------------------------|---------------------------|--------------------|--|----------------------------|--------------------|---------------------------------|
| Greece /total | 181 53% | | 134 50% | | 180 32% | | 214 19% |
| Singapore | 1 | United States | 1 | Denmark | 1 | Luxembourg | 2 |
| New Zealand | 2 | Switzerland | 2 | New Zealand | 2 | Norway | 4 |
| United States | 3 | Denmark | 3 | Sweden | 3 | Iceland | 6 |
| Hong Kong | 4 | Sweden | 4 | Singapore | 4 | Ireland | 7 |
| Denmark | 5 | Singapore | 5 | Finland | 5 | Denmark | 8 |
| UK | 6 | Finland | 6 | Switzerland | 6 | Switzerland | 10 |
| Ireland | 7 | Germany | 7 | Iceland | 7 | Sweden | 13 |
| Canada | 8 | Netherlands | 8 | Netherlands | 8 | Netherlands | 14 |
| Australia | 9 | Japan | 9 | Australia | 9 | Finland | 15 |
| Norway | 10 | Canada | 10 | Canada | 10 | Australia | 16 |
| Iceland | 11 | UK | 12 | Luxembourg | 11 | UK | 17 |
| Japan | 12 | Austria | 14 | Austria | 12 | United States | 18 |
| Sweden | 17 | Norway | 15 | Hong Kong | 13 | Austria | 19 |
| Belgium | 19 | France | 16 | Germany | 14 | Belgium | 22 |
| Switzerland | 21 | Taiwan | 17 | Norway | 15 | Canada | 23 |
| Estonia | 22 | Australia | 18 | Ireland | 16 | Australia & NZ | 24 |
| Korea | 23 | Belgium | 19 | UK | 17 | Germany | 25 |
| Mauritius | 24 | Iceland | 20 | Belgium | 18 | France | 26 |
| Germany | 25 | Ireland | 22 | Japan | 19 | Italy | 32 |
| Netherlands | 26 | New Zealand | 24 | USA | 20 | Japan | 33 |
| Austria | 27 | Luxembourg | 25 | Chile | 23 | Spain | 35 |
| France | 31 | Chile | 28 | France | 24 | New Zealand | 37 |
| South Africa | 32 | Spain | 29 | Uruguay | 25 | Hong Kong | 39 |
| Slovakia | 36 | China | 30 | Slovenia | 26 | Greece | 40 |
| Chile | 40 | Estonia | 32 | Spain | 30 | Cyprus | 42 |
| Hungary | 41 | Czech Rp | 33 | Cyprus | 31 | Bahrain | 43 |
| Tonga | 43 | Thailand | 34 | Portugal | 32 | Puerto Rico | 45 |
| Armenia | 44 | Kuwait | 35 | Dominica | 33 | Israel | 46 |
| Bulgaria | 45 | Tunisia | 36 | Taiwan | 39 | Slovenia | 47 |
| United Arab Emirates | 46 | Cyprus | 40 | South Korea | 40 | Portugal | 48 |
| Romania | 47 | Puerto Rico | 41 | Latvia | 52 | Czech Republic | 55 |
| Portugal | 48 | Slovenia | 42 | Slovakia | 53 | Estonia | 56 |
| Spain | 49 | Portugal | 43 | South Africa | 54 | Saudi Arabia | 60 |
| Luxembourg | 50 | Lithuania | 44 | Italy | 55 | Hungary | 61 |
| Turkey | 59 | Slovak Rpb | 46 | Seychelles | 56 | Slovakia | 62 |
| Italy | 65 | Italy | 49 | Greece | 57 | Antigua | 63 |
| Dominica | 74 | Turkey | 63 | Lithuania | 58 | Latvia | 66 |
| Albania | 86 | Brazil | 64 | Poland | 59 | Lithuania | 67 |
| Marshall Islands | 93 | Montenegro | 65 | Turkey | 60 | Croatia | 68 |
| Serbia | 94 | Kazakhstan | 66 | Namibia | 61 | Poland | 69 |
| Papua New Guinea | 95 | Greece | 67 | | | Russian Federation | 73 |
| Greece | 96 | Romania | 68 | | | Venezuela | 74 |
| Dominican Republic | 97 | | | Sudan | 175 | | |
| | | | | Afghanistan | 176 | | |
| | | Mauritania | 131 | Haiti | 177 | Liberia | 211 |
| Guinea-Bissau | 179 | Burundi | 132 | Iraq | 178 | Zimbabwe | 212 |
| Central African Republic | 180 | Zimbabwe | 133 | Myanmar | 179 | Congo | 213 |
| Congo, Dem. Rep. | 181 | Chad | 134 | Somalia | 180 | Burundi | 214 |

4. Facets and evidence of institutional weakness and poor governance

Figure 14

| Administrative costs by Member State | | | | | | | | | | | | | | | | | | | | | |
|--|-----|-----------------|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----------------|-----|-----|-----|-------|
| | AT | BL ² | CZ | DE | DK | ES | FI | FR | UK | GR | HU | IE | IT | NL | PL | PT | RE ² | SK | SI | SE | EU-25 |
| Administrative cost share in GDP (in %) ¹ | 4.6 | 2.8 | 3.3 | 3.7 | 1.9 | 4.6 | 1.5 | 3.7 | 1.5 | 6.8 | 6.8 | 2.4 | 4.6 | 3.7 | 5.0 | 4.6 | 6.8 | 4.6 | 4.1 | 1.5 | 3.5 |
| ¹ Based on Kox (2005): Intra-EU differences in regulation-caused administrative burden for companies. CPB Memorandum 136. CPB, The Hague. ² BL combines Belgium and Luxembourg; RE combines the Baltic Member States, Malta and Cyprus; EU-25 figures are GDP-weighted averages | | | | | | | | | | | | | | | | | | | | | |

Consequently, the OECD Regulation Database, the World Economic Forum competitiveness survey, the World Bank “Doing Business” and Governance Indicators and European Commission estimates (EC, 2006; EU 2002), to name a few, all find that in Greece the administrative burden is also exceptionally high (Figure 14), that regulation of markets is excessive, that government intervention limits competition as well as resource allocation and pricing decisions in crucial network industries, that the regulation of professional services (Figure 15) is high as far as entry and price setting is concerned at the same time that qualitative standards are excessively lax (Paterson et al. 2003), and that the business environment, as an aggregate, is unattractive.

Figure 15

| Composition of Regulation Indices constructed by Paterson et al. 2003. | | |
|--|---------|------------------|
| | Lawyers | Notaries Public* |
| Austria | 7,3 | 5 |
| Belgium | 4,6 | 4,3 |
| Denmark | 3 | |
| Finland | 0,3 | |
| France | 6,6 | 4,8 |
| Germany | 6,5 | 5,0 |
| Greece | 9,5 | 4,8 |
| Ireland | 4,5 | |
| Italy | 6,4 | 4,3 |
| Luxemburg | 6,6 | 4,6 |
| Netherlands | 3,9 | 3,8 |
| Portugal | 5,7 | 3,9 |
| Spain | 6,5 | 4 |
| Sweden | 2,4 | |
| UK/ E & W Barristers | 4,6 | |
| UK | 3,5 | |

*Arithmetic mean of market entry regulation indexes.

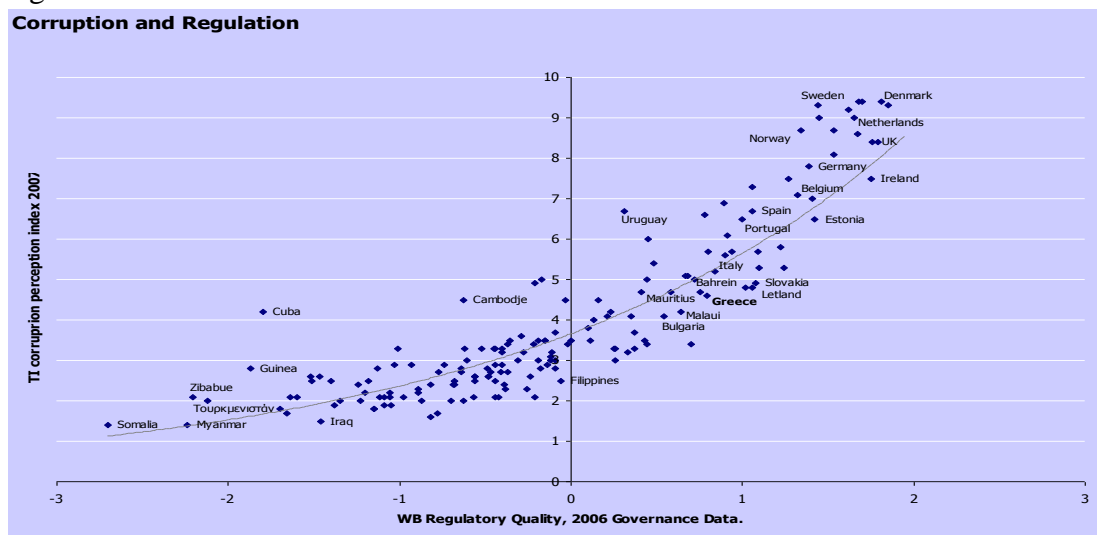
*Lawyers: 0=less regulated. 10=more regulated, rigid.

Notaries public: 0=less regulated market entry. 5=more regulated market entry

These findings are complemented by more general statements that indicate weak institutions, poor governance (Kaufmann, Kray and Mastruzzi, 2005) and high levels of corruption that seem to follow as a consequence of the high administrative burden and the poor governance (Ackerman, 2006).

All the abovementioned recent research and the detailed presentation of numerous pieces of evidence indicate that the wide range of institutional weaknesses that prevail in Greece account, as a whole, for this dismal performance. As a matter of fact, the magnitude of the weaknesses documented by these pieces of evidence is the only observation available that has a magnitude that could match the size of the competitiveness deficit documented for Greece by the inflation differential with the euro zone, the current account deficit and the low level of FDIs. It has to be added that, not surprisingly, Greece is found to be the OECD country which has the most to gain from rectifying these documented deficiencies, like product market regulation (Conway, et al. 2006), in terms of increased productivity. This performance can be labeled “dismal” not because of its absolute level, but because of the large discrepancy between the performance of the country on all these aspects and the per capita GDP that it has achieved in the past years. In particular, following the strong performance till the 70’s and the strong performance of the past years, per capita GDP is relatively close to the per capita GDP of the other OECD and EU member countries. And while Greece remains among the poorer members of these groups, it still can distance itself clearly from most other countries that do not participate in these two groups of privileged countries. On the other hand all the other performance indicators are clearly much weaker than the performance of all other OECD and EU member countries. Here Greece clearly is placed, repeatedly, in the middle of the sample of all the countries in the world, and not in the top 20% of the countries, as is the case with per capita GDP. Greece, ultimately, emerges as a country with almost first-class per capita GDP but clearly second-class governance, institutions, business environment and corruption (Figure 16).

Figure 16



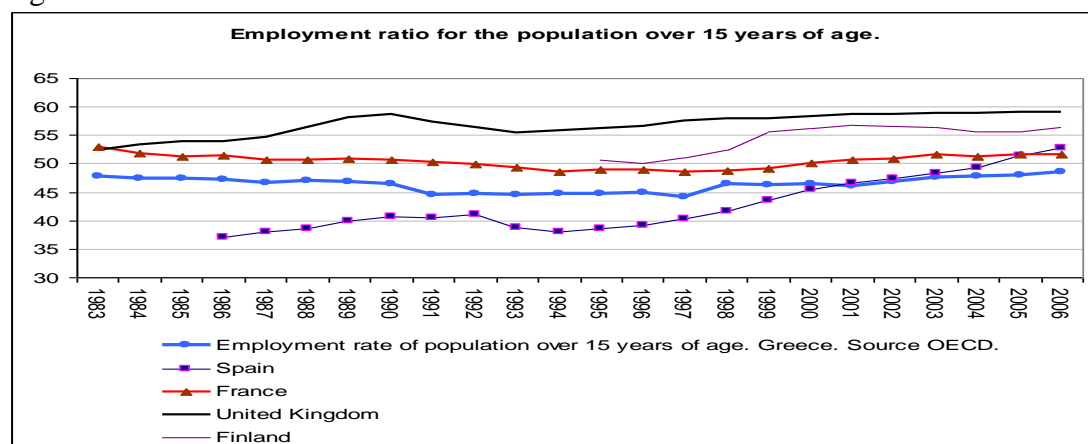
The factors that were analyzed previously and that document why Greece grew so fast in spite of these shortcomings can also reconcile the recent performance of Greece with the now extended literature, mainly of OECD Economic Department Working

Papers⁴, that directly link the performance of an economy with the quality of the regulatory framework and the prevalence of competitive markets. In a similar way one can reconcile also almost all of the other weak performances of the country, that range from research and innovation⁵ to the protection of the environment, the quality of public health services and schools and the performance of the higher education system⁶. Even the weak performance of the judiciary can be ultimately linked to this pattern⁷.

5. A note on the labor factor of production. The paradox of the underlying ‘high labour productivity’ in a low competitiveness context

The result of the strong demand growth that is not driven by an increase in domestic supply that follows from an increase in employment (Figure 17),

Figure 17



directly affects the reliability of productivity indexes that measure GDP to labour input, -and that give a % of around 2.5%-3% for Greece during these years- in various forms. This follows as the increase in the numerator (GDP), matches a restrained increase in the denominator as you can see for yourself in the following Figure 18, thus measuring a large increase in the productivity per worker or per hour worked, in spite of the dismal performance of the Greek economy as measured by the closeness of relevant product markets (Figure 18). It follows from the previous exposition that the use of such indicators is not correctly capturing the variety of the parameters that shape the performance of the Greek economy during the past decade, often depicting Greece in a position that doesn't favour the drawing of reliable conclusions. This gives also an explanation to the puzzle of having on the one side

⁴ An indicative selection of related OECD publications is: (1) OECD (2007a) (2) Conway, P., D. de Rosa, G. Nicoletti and F. Steiner. (2006) (3) Bassanini, A. and R. Duval. (2006). (4) Nicoletti, G. and S. Scarpetta (2005). (5) Nicoletti, G. and S. Scarpetta (2006). (6) Conway, P., V. Janod, G. Nicoletti (2005). (7) Bassanini, A. and E. Ernst. (2002). (8) Scarpetta, S., P. Hemmings, T. Tressel and J. Woo. (2002). (9) Scarpetta, S. and T. Tressel (2002). (10) Nicoletti, G. and S. Scarpetta. (2003). (11) OECD (2003) (12) Alesina, A., S. Ardagna, G. Nicoletti and F. Schiantarelli. (2003). (13) Nicoletti, G. A. Bassanini, E. Ernst, S. Jean, P. Santiago and P. Swaim. (2001). (14) Conway, P. & G. Nicoletti. (2006).

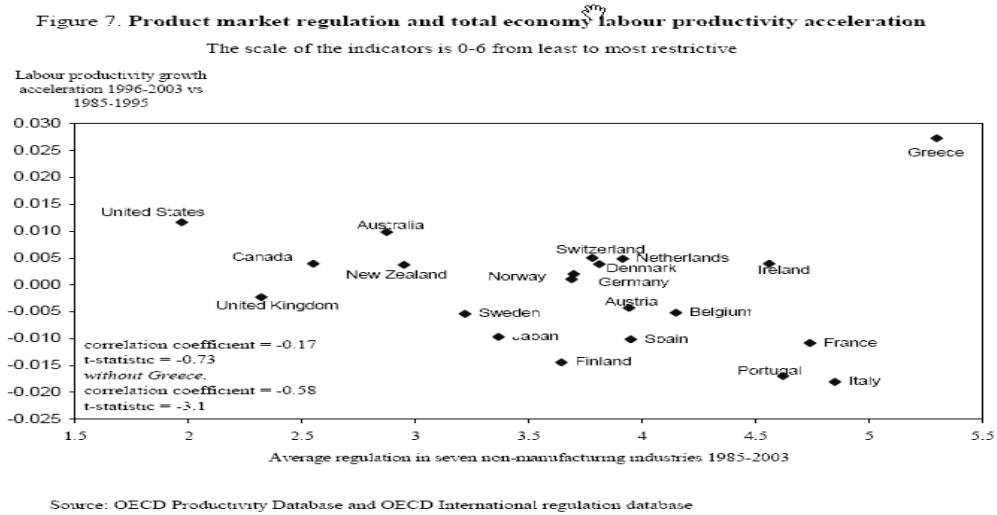
⁵ Bassanini, A., S. Scarpetta and I. Visco. (2000).

⁶ (1) Bassanini, A. and S. Scarpetta. (2001). (2) Mitsopoulos, M. and T. Pelagidis (2007). (3) OECD (2007b), *Economic Surveys: Greece*, May.

⁷ (1) Mitsopoulos, M. & T. Pelagidis (2007). (2) Djankov, S., La Porta de-Silanes & A. Shleifer (2002).

high GDP and productivity rates, and on the other side low competitiveness with twin deficits. At least to the extent we take into account only domestic forces and not taking into account factors such as euro's overvaluation⁸ and the asymmetric demand shocks.

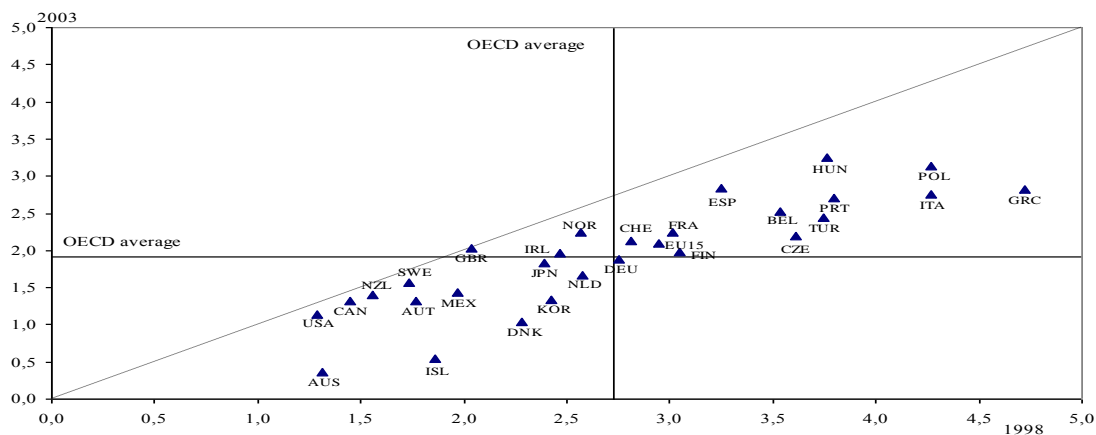
Figure 18



Source: Graph from P. Conway, D. De Rosa, G. Nicoletti and F. Steiner (2006), "Regulation, Competition and Productivity Convergence", OECD ECO Working Paper 509.
0=less regulated. 6=more regulated, rigid.

In this context, it worth looking more on some other aspects of institutional rigidities which complement very well low competitiveness. Figure 19 summarize in particular the product market regulation having an impact on economic behaviour, including private governance and product market competition such as state-control and legal barriers to entry in a competitive market. Greece, after Poland and Hungary, has the most regulated product market, with harmful microeconomic effects such as price distortion and an unfortunately low usage of labour, to name just a few.

Figure 19 Product market regulation. Degree of restrictiveness of regulation having an impact on economic behaviour

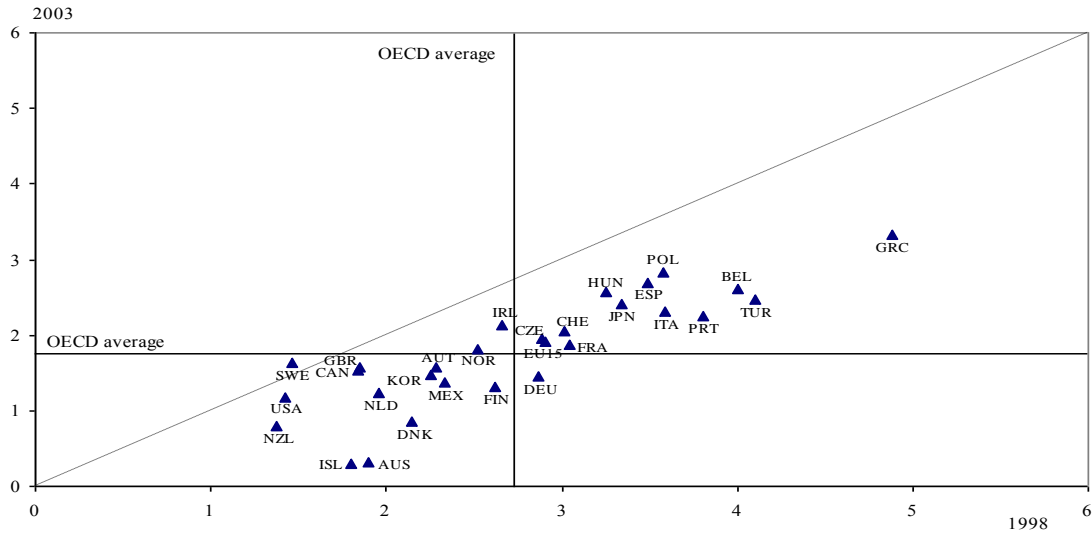


Source: OECD (2006)
0=less regulated. 5=more regulated, rigid.

⁸ At least to the extent that Greece's trade take place with outside EU partners (around 50% of total).

Figure 20 concerns the state involvement in business operations via price controls or the use of command and control regulation. ‘Command and control’ includes a lot of administrative mechanisms of hindrance of entrepreneurial activity/organization, in sectors such as ‘road and railway transports’ and retail trade.

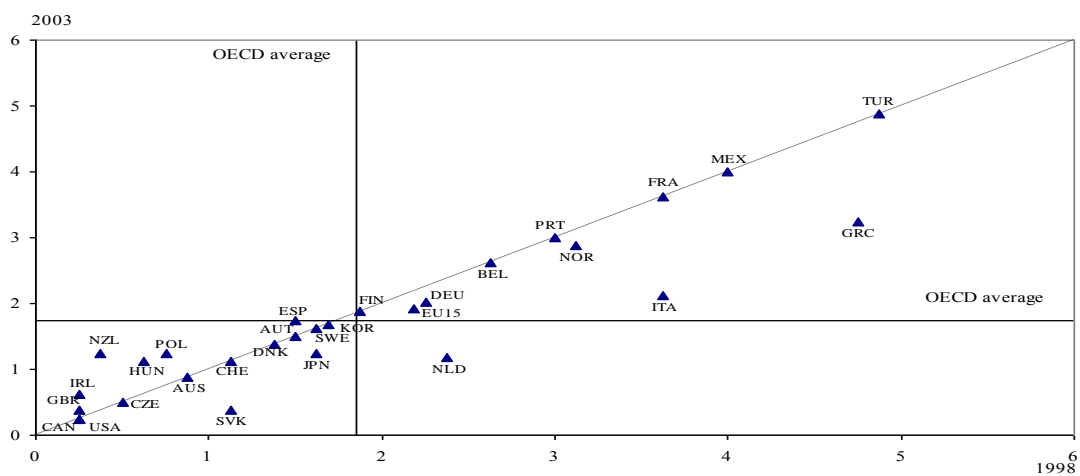
Figure 20 Restrictiveness of regulatory burden on business procedures



0=less regulated. 6=more regulated, rigid.

Product markets rigidities is of critical importance for rigidities in the labour markets as well. Figure 21 shows Greece among OECD countries with the highest employment protection legislation (EPL). It should be noted here that the market for non-permanent, temporary employment in Greece is the main reason for the exceptional rigidity of the Greek labour market overall, but that the market for permanent contracts is also relatively rigid when compared with other OECD countries.

Figure 21 Employment Protection Legislation



0=less regulated. 6=more regulated, rigid.⁹

⁹ However, the above data does not include the so-called ‘shadow economy’, which in the case of Greece it is estimated around 20-30% of the official GDP. The ‘black labour market’, as part of the

These kind of structural institutional rigidities constitute a true cost to society in the environment of a non-competitive economy like the Greek economy. It means and leads to the exclusion of many others from the labor market, and especially the young that seek salaried labor. Under 26 years old unemployment is more than 35% and 20% for women and men correspondingly today. This should be read as underutilization of a dynamic labor force, and should not be considered solely as a major social or ethical issue. Also, one should be right to suppose that the riots of December 2008 had their roots on the marginalization of huge masses of unemployed young people.

6. A note on the capital factor of production

A note on constrained profitability in spite of the rapid growth, that also confirms falling competitiveness

It should finally be noted that in spite of the rapid growth of the past years, the total profitability of the Greek corporations seems not to be high, with the exception of a spike around 1999 and 2000 (Figure 22 & 23). Of course the absolute magnitude of profits has risen with the fast growth of the nominal GDP, but the profitability ratio has not risen to high levels. This may of course also follow from the intensive use of capital that drives down the marginal yield of investments, but it seems reasonable that the very high administrative cost measured by the European Commission and other institutions also contributes to a reduction of the profitability ratios, in spite of the high inflation differential with the euro zone. Still, many studies for profitability, like from the European Commission, add to the corporate profits the income of the self-employed. Because in Greece they are widespread, and because the high possibility that they massively substitute salaried labour, such approaches do not measure the profitability of the corporate sector in a reliable way.

Figure 22



It should be added here that the picture of corporate profitability that emerges from the analysis of the published balance sheets and income statements of almost all the population of active companies in Greece, draws a very different picture than the one that is drawn from exercises that examine the revenues of a broadened “business sector” that also includes the self-employed because of the exceptionally large

shadow economy, includes a significantly flexible labour market that excludes employees from trade unions’ membership, social protection and insurance, working rights, etc.

prevalence of self-employment in Greece especially for middle and high income earners. Use of the Amadeus database to explore deeper these assertions would indeed be a fruitful avenue for future research.

So, besides employment, also corporate profits remain low in spite of the rapid GDP growth and high inflation.

Figure 23

| Profits before tax and extraordinary to sales, non-financial companies. | | | | | | | | | | |
|--|--------|--|---------|---------|--------|--------|-------|-------------|---------|----------|
| Sectors NACE A to K and M, N,O. Germany C-I only. Italy except M,N. All companies of sample for each year (BACH definition ofr Variable Sample). Data for all countries except Greece BACH, data for Greece from ICAP, yearly edition of Guide to the Greek Company. Full yearly sample, comparable to BACH Variable Sample and same NACE sectors and definition for profit before tax and extraordinary. | | | | | | | | | | |
| | Greece | Weighted average all countries except Greece | Belgium | Germany | Spain | France | Italy | Netherlands | Austria | Portugal |
| 2003 | 5,43% | 4,45% | 5,54% | 3,43% | 7,67% | 4,00% | 3,28% | 6,72% | 5,08% | 6,47% |
| 2004 | 4,97% | 5,38% | 5,84% | 3,42% | 7,66% | 5,41% | 5,05% | 8,39% | 5,62% | 6,85% |
| 2005 | 3,86% | 6,01% | 8,25% | 3,73% | 9,10% | 5,58% | 4,28% | 12,93% | 6,37% | 7,79% |
| 2006 | 5,04% | 6,53% | 7,58% | 4,07% | 10,11% | 6,97% | 4,66% | 12,43% | 5,29% | 7,01% |
| 2007 | 5,68% | 7,17% | 9,57% | 5,98% | 10,28% | 7,51% | 4,74% | | 7,84% | 9,49% |
| 2008 | 3,06% | | | | | | | | | |

7. Conclusions

In this paper we have started out with a brief description and analysis of the prosperous years and at the same time of the falling competitiveness of Greece's economy. We have showed, paradoxically at first sight that high GDP growth rates can very well co-exist with falling competitiveness and continued institutional weakness. We have traced an idiosyncratic 'Dutch disease' that is massive 'inflows' (tourism, structural funds, shipping, public borrowing) and that fueled GDP growth rate but let mostly both the real economy and the economic institutions with obsolete and rigid structures.

We mentioned extensive regulation of markets, high administrative costs, a business environment that is not favorable to entrepreneurship and, in the end, weak convergence and widespread corruption as drivers and cause of this low competitiveness, in spite of the reforms in the credit and telecommunications markets and the benefits accruing from the EMU accession. Greece emerges, therefore, to benefit from certain reforms but on a very large scale because of the nature and importance of these positive developments, while it retains other, also significant in importance and magnitude, weaknesses that undermine the long-term growth potential of the country. These weaknesses are ultimately described as "inefficient *statism*, rigidities, weak non-independent institutions and governance", and their proliferation is deeply built in the equilibrium that is formed today between the interest groups that accrue the rents that they secure through the regulation of markets and the inflation of the administrative costs. One could also argue that the strong growth of the past years has also made the need for further reforms less pressing.

The stakes are the long term growth prospects of the Greek economy, once the rate impact of the reforms of the EU and EMU membership peter out, and what is needed is the relocation towards a new equilibrium in which rents that are accrued from –and through- state intervention and high administrative costs are replaced with profits that accrue from competitive, transparent, well-regulated markets, and that are not distributed on the basis of the ability to secure favors from the executive and legislature, but from innovation driven entrepreneurship in competitive markets.

The current situation requires for a group of reform-minded politicians that will not yield to the pressures of the interest groups and that will have sufficient knowledge to use the significant powers of the government, in spite of the fact that the administration is a weak tool for policy implementation. They will have to significantly change the “rules of the game” by setting the legislative framework for free and competitive markets across the board. This effort must also be complemented with the establishment of sufficient checks and balances and the setting of the legal basis for the widespread establishment of transparency and accountability in all levels of the government and administration, which are also topics for a further research.

References

Ackerman, S.A., ed. 2006. *International Handbook on the Economics of Corruption*, Yale UP.

Bassanini, A., S. Scarpetta and I. Visco. 2000. “Knowledge, Technology and Economic Growth: Recent Evidence from OECD Countries”, OECD ECO WP 259.

Bassanini, A. and S. Scarpetta. 2001. “Does Human Capital Matter for Growth in OECD Countries?”, ECO WP 282.

Bassanini, A. and E. Ernst. 2002. “Labour Market Institutions, Product Market Regulation and Innovation. Cross Country Evidence”, ECO WP 316.

Bassanini, A. and R. Duval. 2006. “Employment Patterns in OECD Countries. Reassessing the Role of Policies and Institutions”, ECO WP 486.

Conway, P., V. Janod, and G. Nicoletti. 2005. “Product Market Regulation in OECD Countries: 1998 to 2003”, OECD ECO WP 419.

Conway, P., D. de Rosa, G. Nicoletti and F. Steiner. 2006. “Regulation, Competition and Productivity Convergence”, OECD ECO WP No. 509.

Conway, P. and G. Nicoletti. 2006. “Product Market Regulation in the Non-manufacturing Sectors of OECD Countries: Measurement and Highlights”, OECD ECO WP 530.

Djankov, S., La Porta de-Silanes and A. Shleifer. 2002. “The Practice of Justice”, World Bank Development Report 2002.

EC (2006), "Measuring Administrative Costs and Reducing Administrative Burdens in the European Union", Commission Working Document COM(2006) 691 final, 14.11.2006

EU. 2002. *Benchmarking the Administration of Business Start-ups*, European Commission Final Report.

Financial Times. 2009. "Deficit Delinquent", Nov. 11.

Gibson, H.D. 2007. "The Contribution of Sectoral Productivity Differentials to Inflation in Greece", Bank of Greece, WP 63.

Hajkova, D., G. Nicoletti, L. Vartia and K-Y. Yoo. 2007. Taxation, Business Environment and FDI Location in OECD Countries. OECD ECO WP 501. Also published in OECD Economic Studies No. 43/1 2007.

Kaufmann, D. A. Kray, and M. Mastruzzi. 2005. "Governance Matters IV". The World Bank.

Mitsopoulos, M. and T. Pelagidis. 2007. "Rent Seeking and Ex-post Acceptance of Reforms in Higher Education", *The Journal of Economic Policy Reform*, 10(3), pp. 219-44.

Mitsopoulos, M. and T. Pelagidis. 2007. "Does Staffing Affect the Time to Serve Justice in Greek Courts?". *International Review of Law and Economics*. June, pp.177-92.

Nicoletti, G., A. Bassanini, E. Ernst, S. Jean, P. Santiago and P. Swaim. 2001, "Product and Labour Markets Interactions in OECD Countries", OECD ECO WP 312.

Nicoletti, G. and S. Scarpetta. 2003. "Regulation, Productivity and Growth. OECD Evidence", OECD ECO WP 347.

Nicoletti, G. and S. Scarpetta 2005. "Product Market Reforms and Employment in OECD Countries. OECD ECO WP 472.

Nicoletti, G. and S. Scarpetta. 2006. "Regulation and Economic Performance: Product Market Reforms and Productivity in the OECD", OECD ECO WP 460.

OECD. 2003. *"The Sources of Economic Growth in OECD Countries"*, Paris, OECD.

OECD. 2007a. *Going for Growth*, Paris, OECD.

OECD. 2007b. *Economic Surveys: Greece*, May, Paris, OECD.

Paterson, I., M. Fink, and A. Ogus. 2003. "Economic Impact of Regulation in the Field of Liberal Professions in Different Member States, Regulation of Professional Services, Final Report-Part3, January 2003, Study by the Institut fuer Hoere Studien, Wien for the European Commission, DG Competition.

Pelagidis, T. and T. Toay. 2007. "Expensive Living: The Greek Experience Under the Euro", *InterEconomics. Review of European Economic Policy*, 42(3), pp. 167-176.

Scarpetta, S., P. Hemmings, T. Tressel and J. Woo. 2002. "The Role of Policy and Institutions for Productivity and Firm Dynamics: Evidence from Micro and Industry Data", OECD ECO WP 329.

Scarpetta, S. and T. Tressel. 2002. "Productivity and Convergence in a Panel of OECD Industries. Do Regulations and Institutions Matter?" OECD ECO WP 342.