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ΕΛΛΗΝΙΚΟ ΙΔΡΥΜΑ ΕΥΡΩΠΑΪΚΗΣ & ΕΞΩΤΕΡΙΚΗΣ ΠΟΛΙΤΙΚΗΣ
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Greek Myths and Reality

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ΕΛΙΑΜΕΠ ELIAMEP

Introduction

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The crisis Greece has been going through has been one of the most serious challenges any country, anywhere, has faced in peace-time. It has also had a big impact on Europe. A successful Greek recovery is crucial, not only for Greece itself, but for the whole of Europe and the eastern Mediterranean region. Greece has and can continue to have a stabilizing role in the region, and has played this role particularly effectively after George Papandreou and the late Ismail Cem, when they were both foreign ministers, brought about much friendlier relations between Greece and Turkey. Greece has also always had very important relations with the United States, with a vibrant Greek-American community constituting a crucial link between the two nations. As Greece is implementing very difficult reforms, support from the United States for Greece's recovery is more important than ever.

As this collection of papers assembled by ELIAMEP shows, the Greek people have shown much courage over the last four years. The adjustment in the balance of payments and in the fiscal accounts has been dramatic. Progress has also been made with the even more difficult and perforce time-consuming structural reforms. On that front, much remains to be done.

We are very happy to post this excellent set of short papers on our Brookings website, within the Global Economy and Development program, at the time of the visit of Prime Minister Samaras to Washington and we are grateful to ELIAMEP for giving us this opportunity.

Kemal Derviş
Vice President and Director
Global Economy and Development Program
The Brookings Institution

Greek Myths and Reality

Loukas Tsoukalis
President of ELIAMEP and Professor of European Integration at the University of Athens

Myth is a Greek word, and Greek mythology has been over the centuries a source of continuous inspiration for many people across the world. Our task here is not to delve into ancient Greek myths and try to decipher them. We have set ourselves instead a much easier task, namely to examine critically some of present day stories and stereotypes about Greece, what we call Greek myths.

Greece has been in the eye of the financial storm that first hit the United States and then Europe during the last few years. Nobody can seriously argue that Greece was caught in the storm as an innocent victim. Its vulnerability has been the product of numerous mistakes and failings. And perhaps unavoidably, Greece has received a great deal of international attention, much of it negative and often undeserved. These are the myths that colleagues will try to debunk armed with arguments and data. But as with most myths, there are usually grains of truth in them.

'The Greek economy is not adjusting'. In fact, the adjustment of the Greek economy in terms of fiscal consolidation, current account balance and structural reform has been truly remarkable during the last three years. It has also been extremely painful. This is now generally recognized by its European partners and international organizations alike. Reform of the state is the mother of battles in Greece – and this inevitably takes longer. Yet, austerity and reform cannot succeed while the economy is imploding and social tension continues to be on the rise. Reform needs time to deliver the goods. In the meantime, Greece needs support from its partners and favorable conditions for growth, which unfortunately do not exist as yet in today's Europe.

'Greeks are lazy and unskilled'. Quite the contrary, compared to other European countries: so suggest the data. But the Greek economy has been inward-looking for very long, with non-tradables accounting for a very large part of it. Labor costs ran much ahead of productivity during the early years of euro membership, while there was little investment and too much consumption. And there is a clear mismatch between education and the labor market. These are some of the things that Greece is now trying to correct.

'Greeks don't pay taxes'. True, but only some of them, not the others who often pay too much. Greece relies mainly on indirect taxes, because they are easier to collect. It has high rates of personal taxation and suffers from large-scale tax evasion. Of course, this has little to do with Greek DNA and much more to do with the weakness of Greek bureaucracy and the tax collection system in particular, as well as with the structure of the Greek economy containing very large numbers of self-employed. This kind of structure is now changing rapidly because of the crisis.

'Greeks are selfish'. There is indeed a long tradition of individualism in the country that coexists with relatively weak institutions. Yet, in times of serious crisis, civil society wakes up and manifests itself in all kinds of ways to help those in need. There have been many examples in the last few years. Thus, Greeks rediscover the bonds that historically hold them together. It had happened before in national disasters and in war.

'The Eastern Mediterranean is a quiet neighborhood, and Greece's role is unimportant'. I suppose if you believe that, you can believe anything. Greece has generally played a stabilizing role in the region, especially in the Balkans after the fall of communist regimes. Foreign policy capabilities have, of course, suffered as a result of the crisis. Soft power needs money, among other things; it also needs self- confidence. In the meantime, Greece's neighborhood has, if anything, become more unstable, a source of tension and the object of interest, if not desire, of several external powers. Energy and population flows are important factors in the geopolitical equation of the region.

We have asked a colleague to contribute a piece on the recent economic debacle in Cyprus, which remains a divided island. *'Cyprus pays for its own failures'.* Is it true? Cyprus surely pays for an over-extended banking sector, a small part of a big international bubble that burst. Cyprus banks pay a big price because of their close involvement in the Greek economy and for having invested heavily in Greek government bonds. Cyprus also pays for having taken a long time to respond to the crisis. Last but not least, it pays heavily because it had little negotiating power and no clear strategy when its European partners decided to shift from bail-outs to bail-ins and use Cyprus as an example - or just an experiment.

We are grateful to the Brookings Institution for having given us this opportunity and for the fruitful collaboration.

“The Greek economy is not adjusting”

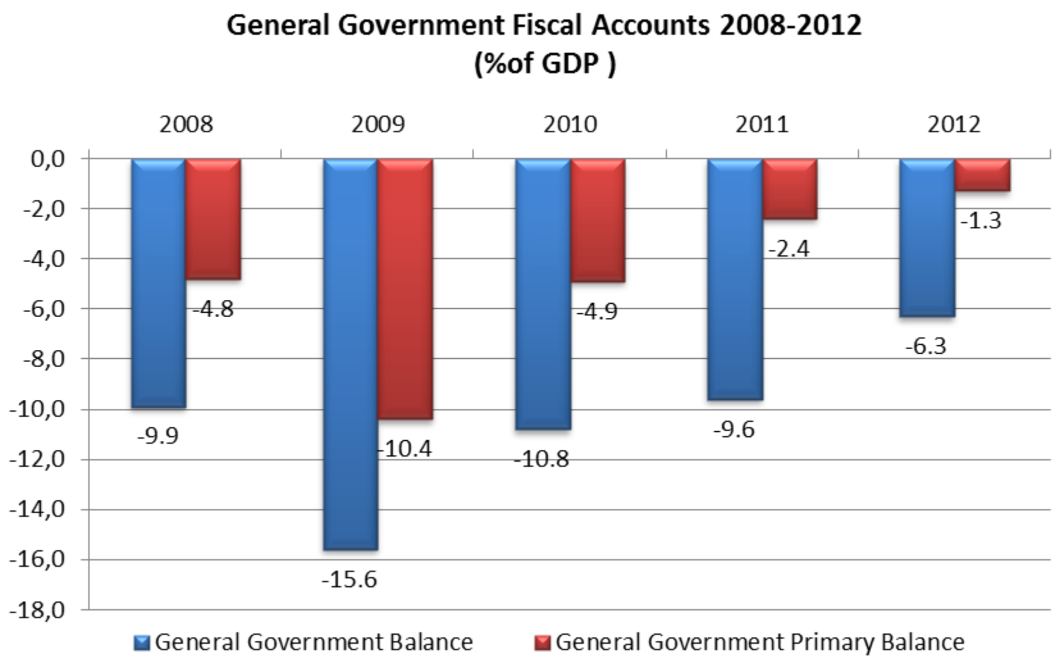
George Pagoulatos

Professor of European Politics & Economy, Athens University of Economics & Business;
Board of Directors, ELIAMEP[1]

Fact 1: The largest fiscal consolidation

During the last 3 years, Greece has achieved one of the largest and fastest rates of fiscal consolidation in the developed world. Between 2009 and 2012, the general government deficit declined by 9.3 percentage points of GDP. A similar reduction of 9.1 percentage points of GDP in just 3 years was recorded in the primary budget deficit (i.e. excluding interest payments on the debt) of the general government (GRAPHS 1 & 2).

GRAPH 1

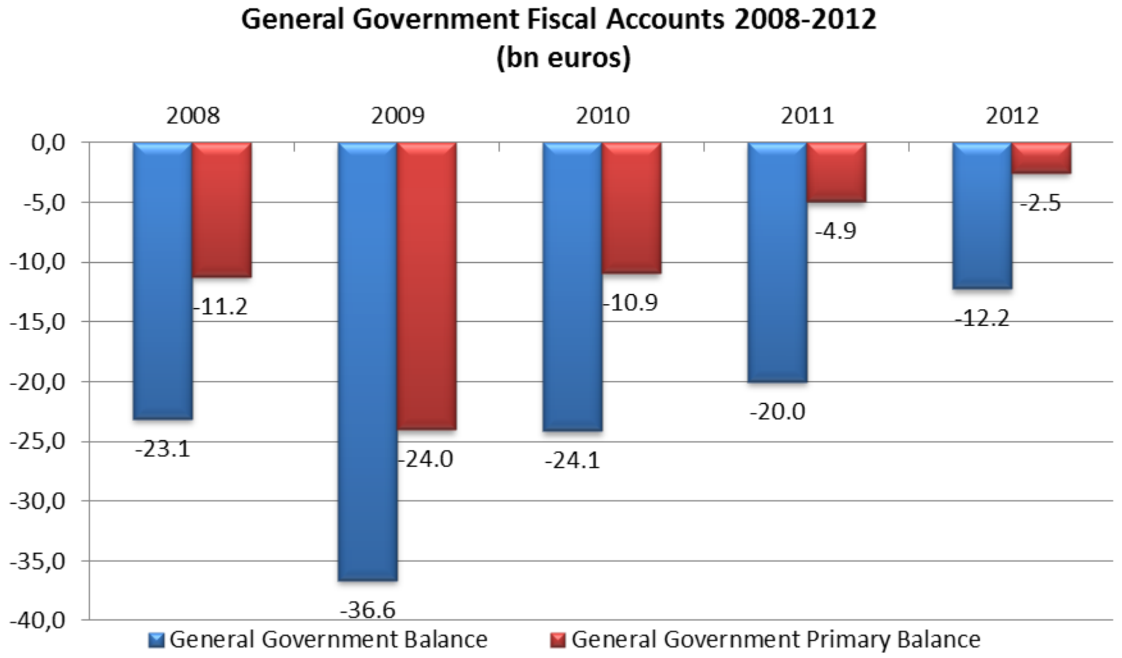


Source: IMF

According to the Euro Plus Monitor (Spring 2013 update), Greece accomplished the most notable fiscal adjustment for 2009-2012 among Eurozone countries and Poland, Sweden, and the United Kingdom. GRAPH 3 shows the cumulative fiscal adjustment since 2009 corrected for the effects of the short-term business cycle, interest rates and some one-off factors.

[1] The author wishes to thank Marianthi Anastasatou for helpful comments, and Dimitra Tsingou for valuable research assistance.

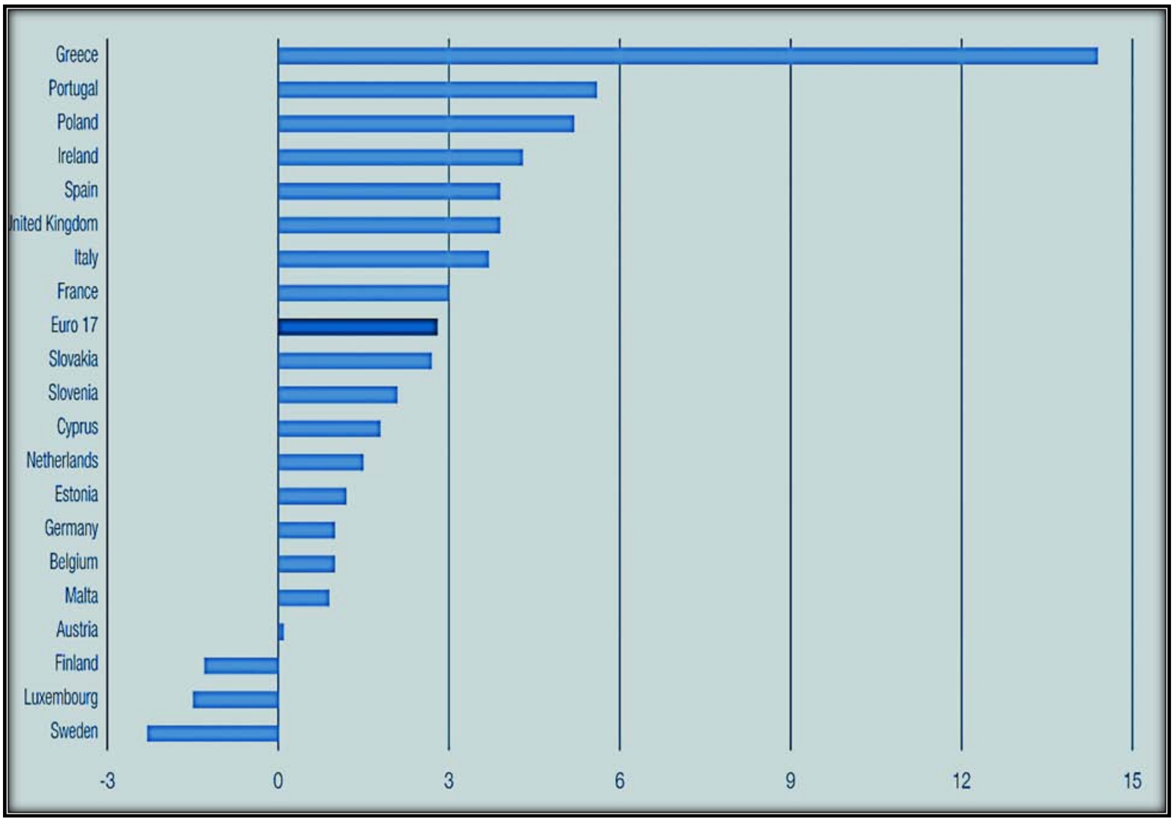
GRAPH 2



Source: IMF

GRAPH 3

Cumulative change in the underlying primary fiscal balance 2012 over 2009, % GDP



Source: Berenberg Bank and the Lisbon Council, The Euro Plus Monitor: Spring 2013 Update, based on European Commission, latest projections

Even the large budget deficit reduction of over 9 percentage points between 2009 and 2012 underplays the actual magnitude of fiscal consolidation that has taken place, if one considers that it unfolded amidst a steep recession. To most accurately appreciate the scope of fiscal consolidation, one should look at (a) the cyclically adjusted budget balance and (b) the structural balance, which is an augmented version of the cyclically adjusted balance.

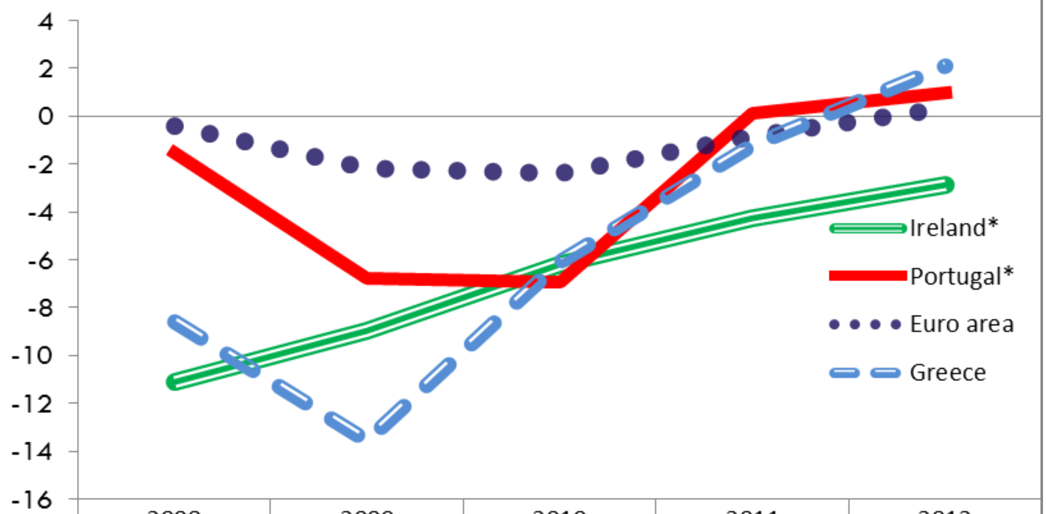
(a) The cyclically adjusted budget deficit of the Greek general government went down from 19.1% of potential GDP in 2009 to 2.7% in 2012, and is projected to reach a surplus of 0.2% in 2013 (IMF Fiscal Monitor, April 2013). The Eurozone average cyclically adjusted budget deficit was 2.4% in 2012 and is projected to be 1.3% for 2013. Thus, adjusting for the cycle, the Greek budget outlook was very close to the Eurozone average in 2012, and will be better than the Eurozone average in 2013.

Similar are the findings if one looks at the cyclically adjusted primary budget deficit, as calculated by the IMF Fiscal Monitor (April 2013). From a cyclically adjusted primary deficit of 13.6% of potential GDP in 2009, Greece posted a cyclically adjusted primary surplus of 2.1% in 2012 and a projected surplus of 4.3% in 2013 (GRAPH 4). This compares to corresponding surplus levels of 0.3% and 1.4% for the Eurozone for 2012 and 2013 respectively.

In other words, in cyclically adjusted terms, Greece has achieved a record fiscal consolidation in the area of 16 percentage points in three years between 2009 and 2012.

GRAPH 4

Cyclically Adjusted Primary Balance (% of potential GDP)



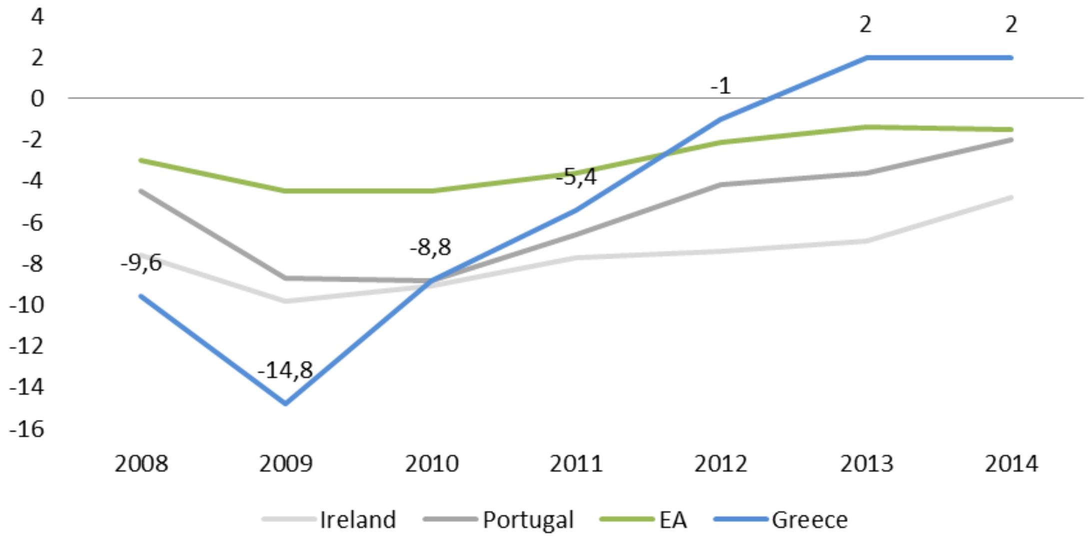
	2008	2009	2010	2011	2012
Ireland*	-11,1	-8,9	-6,2	-4,3	-2,9
Portugal*	-1,6	-6,8	-6,9	0,1	1,0
Euro area	-0,4	-2,2	-2,4	-0,8	0,3
Greece	-8,6	-13,6	-6,1	-1,2	2,1

Source: IMF, *Fiscal Monitor* April 2013

*including adjustments beyond the cycle. Note: Cyclically adjusted primary balance is defined as the cyclically adjusted balance excluding net interest payments

(b) The results are remarkable if one looks at the structural budget balance. According to the standard definition, the structural balance refers to the general government cyclically adjusted balance adjusted for nonstructural elements beyond the economic cycle (such as temporary financial sector and asset price movements, or one-off, or temporary, revenue or expenditure items).[2] The structural balance is the crucial indicator of fiscal discipline in the Eurozone. The EMU Fiscal Compact prescribes that the structural deficit should not exceed 0.5% GDP.[3]

GRAPH 5
Structural Budget Balance,
General Government (% GDP)



Source: European Commission, European Economic Forecast, Statistical Annex, Spring 2013

According to the European Commission data, in 2009 Greece had the highest structural budget deficit in the Euro-area (EA): 14.8% GDP, against an EA average of 4.5% (the second highest was Ireland with 9.8%). By 2012, the Greek structural budget deficit had been reduced to 1% GDP, and a structural budget surplus of 2% is expected in 2013 (GRAPH 5). The corresponding structural deficit rates of the Eurozone for 2012 and 2013 are 2.1% and 1.4% respectively. According to the European Commission data (Spring 2013), among all EA member states, Greece had the 5th best structural budget balance performance in 2012, and is expected to have the best performance in 2013. In just four years (2009-13), Greece has shifted from having the worst to achieving the best structural budget balance position in the Eurozone!

This huge fiscal consolidation has been the result of a most rigorous and heavily frontloaded austerity program. The severity of the adjustment has taken a heavy toll on the real economy, Greece having lost over 25% of its 2008 GDP. The scale and intensity of fiscal consolidation have aggravated the recession, and the latter has undermined the

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[2] See Fabian Bornhorst, Gabriela Dobrescu, Annalisa Fedelino, Jan Gottschalk, and Taisuke Nakata, "When and How to Adjust Beyond the Business Cycle? A Guide to Structural Fiscal Balances", IMF, April 2011.

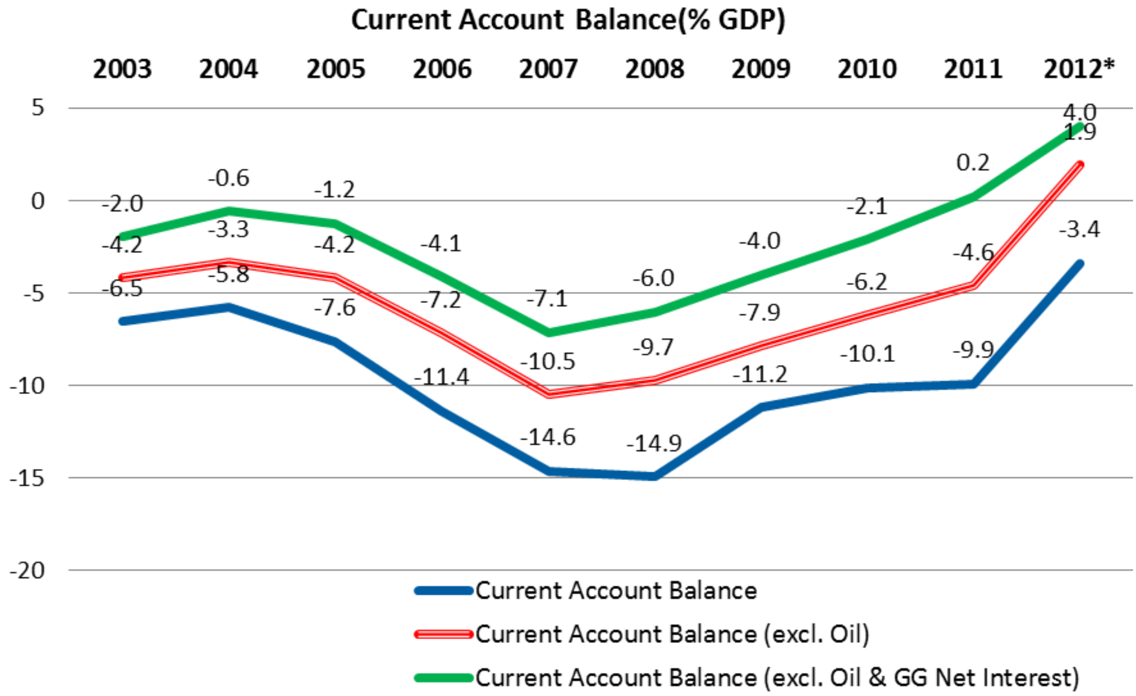
[3] Treaty on Stability, Coordination and Governance in the EMU, Title III, Fiscal Compact, Article 3.

effectiveness of the fiscal consolidation effort. As a result of the steep loss of output, the public debt/ GDP ratio has deteriorated, despite a voluntary haircut of the privately-held public debt in spring 2012 (PSI)) and the debt buy-back later that year. According to the European Commission July 2013 data, the public debt is now at 160% GDP. Given the fast rate of budget deficit reduction, the worsening of the public debt/ GDP ratio is mainly a function of the steep decline of the denominator. A further continuation of recession through additional rounds of austerity, apart from its other obvious severe socioeconomic effects, would also end up undermining any expectation of achieving debt sustainability.

Fact 2: Great improvement in the current account

In 2009-10, the institutional partners and the markets looked, among others, at two main variables and concluded that the Greek economy was not sustainable. The first was the fiscal outlook, which we already discussed. The second was the huge current account deficit near 15% GDP, indicating among others a severe loss of relative competitiveness over the previous period, but also a systemic problem of macroeconomic imbalances in the functioning of the Eurozone. Since 2010, a visible improvement on the current account has been recorded, reflecting the rapid decline of imports as a result of the steep recession, but also a pick-up of exports over the recent period. Between 2008 and 2012, the current account deficit declined by 11.5 percentage points of GDP, falling from 14.9% of GDP in 2008 to 3.4% of GDP in 2012. For 2012, the current account excluding oil and general government net interest, posted a surplus of 4.0% of GDP (GRAPH 6).

GRAPH 6



Source: Bank of Greece, *tentative figures

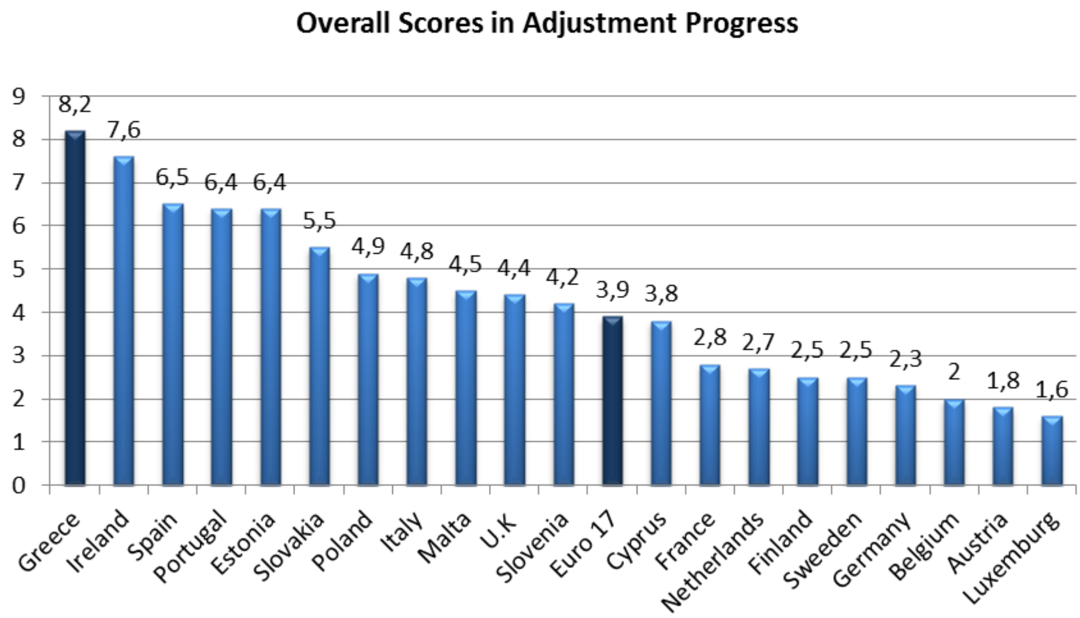
Fact 3: Leading in overall adjustment and reform progress

The 2009-10 the crisis found the Greek economy in a poor state not just in terms of macroeconomic imbalances but also in terms of a number of structural indicators concerning the functioning of the public sector and the markets. The period under the euro had bred complacency, which led to postponement of necessary reforms. Under the pressure of externally imposed conditionality, a wide range of reforms were undertaken, in the public administration and local government, tax administration, the pension system, the health sector, the labor markets, the markets for products and services, etc. Though a lot still remains to be done, the scope of reforms already undertaken can hardly be denied.

According to the Adjustment Progress Indicator (Euro Plus Monitor: Spring 2013 update), Greece ranks first among the Eurozone countries and Poland, Sweden, and the United Kingdom in overall scores of adjustment progress in its economy from 2012 to Spring 2013 (GRAPH 7).

The Adjustment Progress Indicator takes into account three measures of adjustment: 1) a reduction (or increase) in the fiscal deficit, adjusted for interest payments and cyclical factors, 2) the rise (or fall) in exports relative to imports in the external accounts, and 3) changes in unit labor costs. In addition to these three measures of adjustment, it also includes the results of the OECD 2013 annual assessment of pro-growth structural reforms as a further component of the overall Adjustment Progress Indicator.

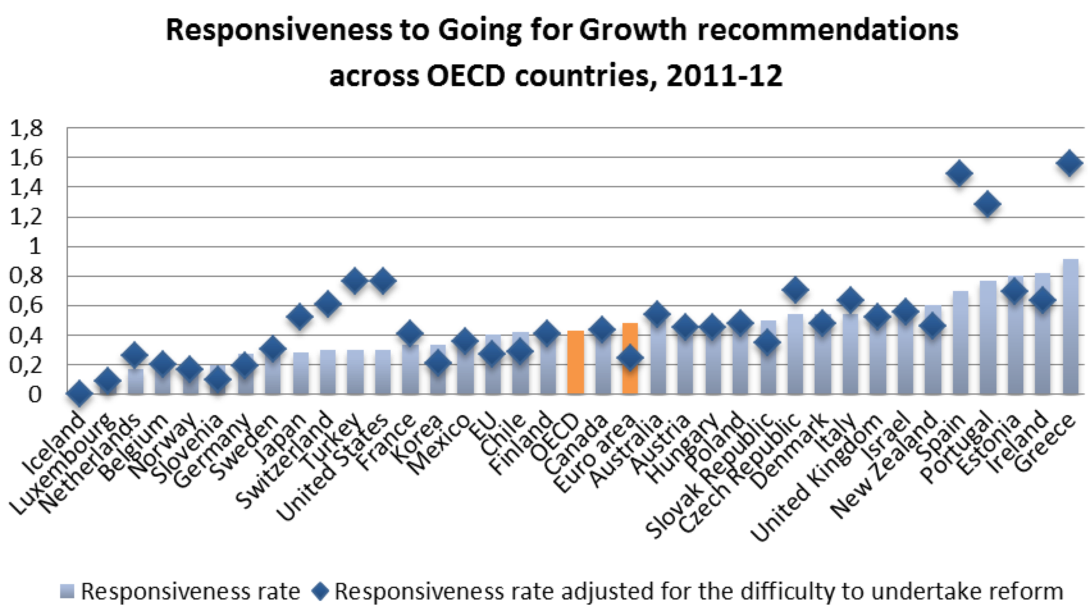
GRAPH 7



Source: Berenberg Bank and the Lisbon Council, The Euro Plus Monitor: Spring 2013 Update, based on Eurostat, ECB, European Commission, OECD and Berenberg calculations.
Note: The total score is the average of the four subscores for external adjustment, fiscal adjustment, labor cost adjustment and reform drive, all on a scale of 10 (best) to zero.

Similar are the findings of the OECD *Going for Growth* Report (2013). According to the OECD, Greece is making the largest progress in reforms, listed first in "Responsiveness to *Going for Growth* recommendations" among OECD countries (GRAPH 8). It should be noted that the difficulty in undertaking reforms is far greater under the existing adverse macroeconomic conditions, the deep recession, high rate of unemployment and steep wage reductions in the public sector. We know from standard political economy literature that reforms are better advanced in good times, when socioeconomic groups feel greater confidence in the future, when jobs are available in the private sector to absorb public sector layoffs and when losers of reforms can be compensated. None of these conditions have held over the last 3 years; the public sector is being downsized as unemployment is mounting, the tax burden of taxpayers is rising as their incomes are falling, and state employees are called to become more efficient and productive while their wages have suffered serious nominal cuts. Still, fast progress in structural reforms even under such adverse circumstances is necessary to create the conditions for a sustainable recovery.

GRAPH 8



Source: OECD, Economic Policy Reforms 2013: Going for Growth

Fact 4: Austerity alone will not do the job

Contrary to popular myths and stereotypes of a "non-reforming Greece", in little over than 3 years Greece has covered a record distance in terms of both fiscal and external economic adjustment. The earlier deficits have been eradicated and unit labor costs have significantly declined. The intensity and scope of this adjustment, however, has come at a huge cost, and is testing the extreme limits of socioeconomic endurance.

Greece is facing a Great Depression, having lost over one fourth of its 2008 GDP, with unemployment hovering at 27% and youth unemployment at 60% levels. Much of the large output loss has resulted from the fiscal consolidation and internal devaluation policies and has been aggravated by the uncertainty surrounding the functioning of the Eurozone. Indeed, until late 2012, the "currency redenomination risk" was cancelling the adjustment efforts, freezing investment and causing capital flight, worsening the recession, thus leading to target slippage, necessitating more fiscal measures, and so on. In that, Greece is part of a wider problem of a growing fragmentation and polarization in the Eurozone, subject to a heavily procyclical market climate, a vicious cycle of contagion between sovereign and banking sector and a prolonged credit crunch with disproportionately high capital costs in the South compared to the Eurozone core member states. Such conditions are not only accentuating sociopolitical and economic risks in the periphery, including the prospect of a lost generation of unemployed youth; they are also diminishing the potential output and undermining the huge adjustment effort undertaken.

The adjustment process through structural reforms at national level must continue; but it needs to be supported by:

(i) faster steps towards banking, fiscal and economic integration in the Eurozone, along the lines of the Presidents Van Rompuy and Barroso proposals;

(ii) a brave, Marshall-plan like countercyclical investment stimulus and employment support to Greece and the other Eurozone Southern economies in recession, to accelerate a return to sustainable recovery;

(iii) a more symmetric distribution of the adjustment between Eurozone core and periphery, with some demand stimulus and a relatively higher rate of inflation in the core economies to assist adjustment in the South.

The Greek economic crisis was mainly the result of national policy failures but also that of the Eurozone's systemic defects. As the first are being corrected, it is also imperative to address the latter by pursuing a more cohesive, integrated and viable Eurozone that can still be around for the next generation. Now that national responsibility is being regained, a new European integration impetus must be released, based on European solidarity, which is the highest form of "enlightened self-interest" of EA member states.

“Greeks are Lazy and Unskilled”

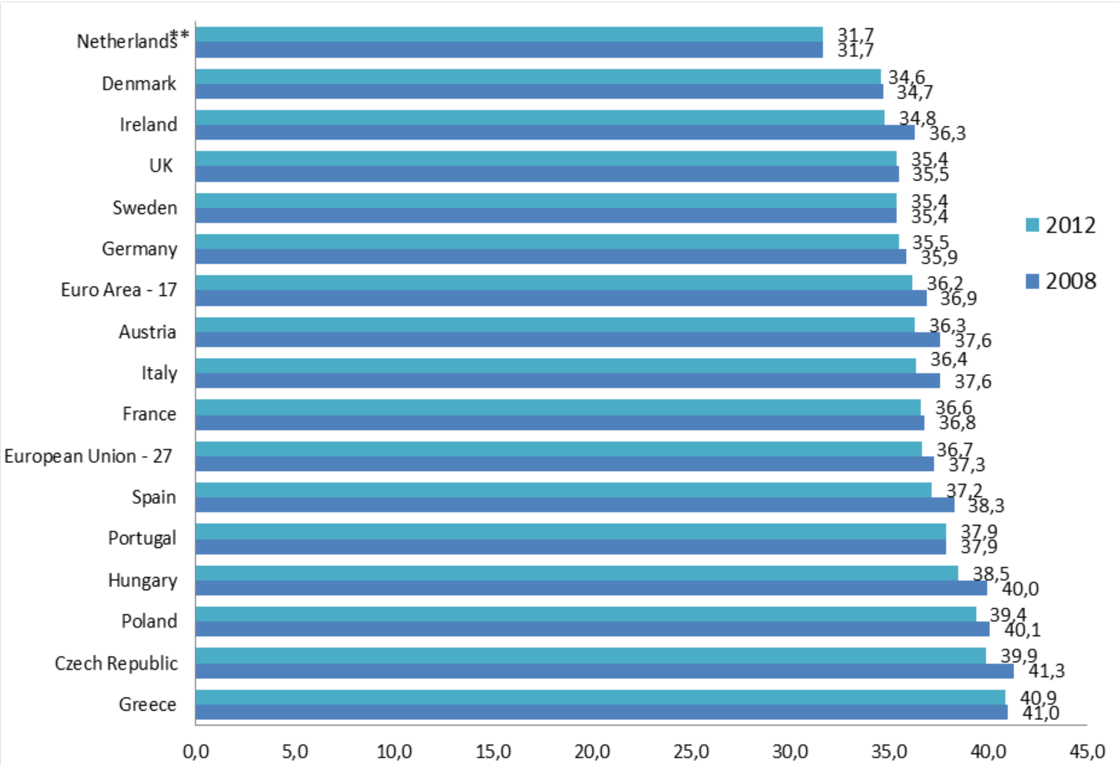
Dimitris Katsikas
Head, Crisis Observatory (ELIAMEP) and

Kyriacos Filinis
Postdoctoral Research Fellow, Crisis Observatory (ELIAMEP)

A fallacious assertion

The narrative of the crisis has been very different in the creditor countries of Northern Europe and the debtor countries of the European periphery. The debate in the latter reflects public resentment for the imposition of harsh austerity measures by creditor countries, while the debate in the latter has tended to stress past mistakes of the countries in the periphery, which are now bailed-out by the countries of the North. Greece, which has been at the epicenter of the crisis, has often been the target of such criticism. One of the most often heard reproaches towards Greece in this context, has been a perceived lack of work ethic and skills, which supposedly is one of the root causes of the Greek crisis. In other words, the allegation is that “Greeks are lazy and unskilled”. This narrative has been reproduced repeatedly in the media of creditor countries and has even been exploited for political purposes by parts of their political establishment. Despite its popularity in some countries, this perception is not borne out by data, which shows a completely different picture.

Figure 1. Average number of actual weekly hours worked in main job*



Source: Eurostat. * Actual hours worked are the hours that a person spends in work activities during one week, and include factors such as overtime, while excluding factors such as travel time between home and place of work, main meal breaks, etc. **Data refers to years 2008 and 2011.

When we look at the average number of hours that a person works each week in the EU (Figure 1), we see that in 2012 Greeks worked on average more than anyone else in the EU. The average working week in Greece is 40.9 hours, compared to 37.2 hours in Spain, 37.9 hours in Portugal, 36.6 hours in France, 35.5 hours in Germany and 34.6 hours in Denmark. Indeed, the Greek working week is substantially longer that both the European Union average week at 36.7 hours and the Euro-area average week at 36.2 hours.

Table 1. Average collectively agreed normal annual working time (2012)

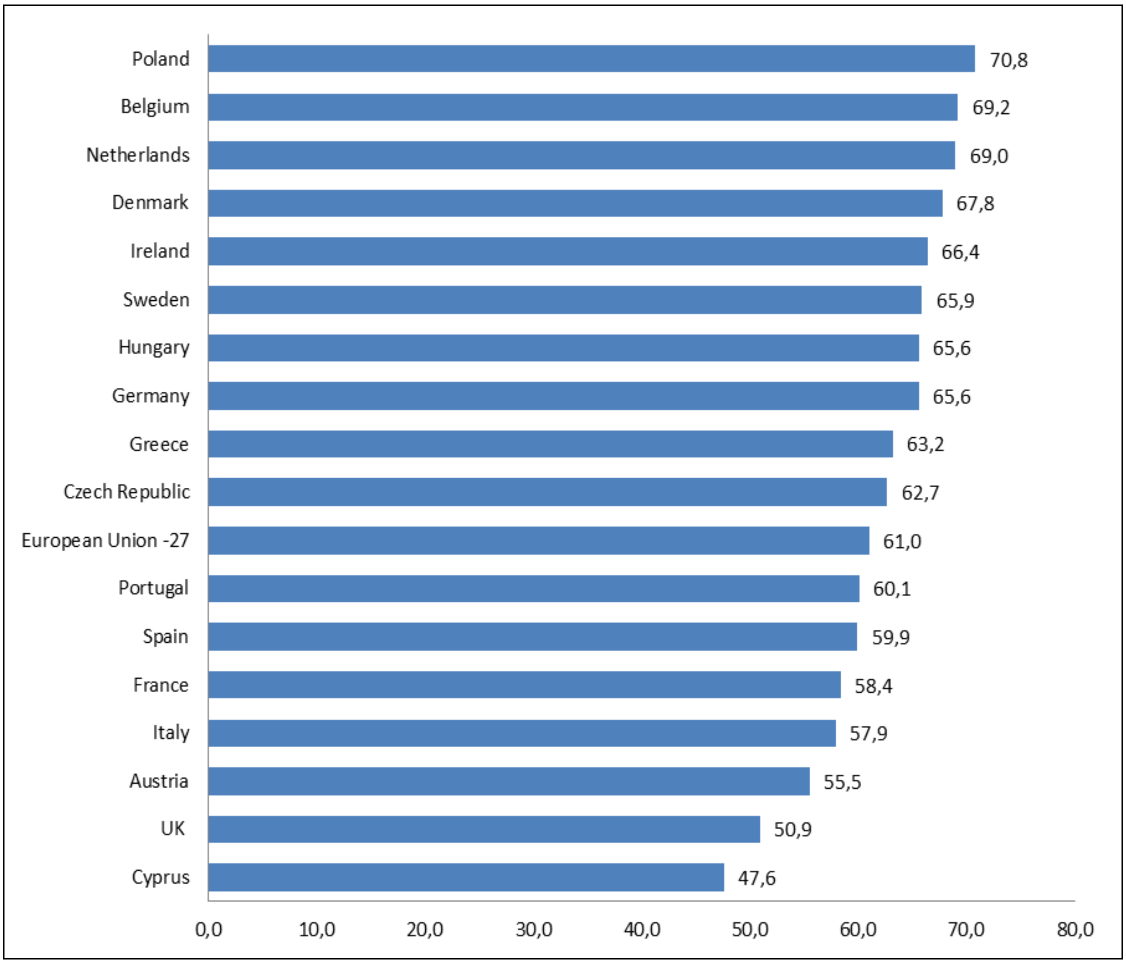
	Weekly hours (collectively agreed)	Annual leave days	Public holidays (days/ year)	Total hours away from work	Net annual work hours (excluding total hours away from work)
Belgium	37.8	20*	10	226.8	1,738.8
Czech Republic	38.0	25	10	266.0	1,710.0
Denmark	37.0	30	8	281.2	1,642.8
Germany	37.7	30	10	301.6	1,658.8
Ireland	39.0	24	8	249.6	1,778.4
Greece	40.0	23*	9	256.0	1,824.0
Spain	38.3	22*	12	260.4	1,731.2
France	35.6	30*	9	277.7	1,573.5
Italy	38.0	28*	11	296.4	1,679.6
Cyprus	38.0	20*	11	235.6	1,740.4
Hungary	40.0	20*	9	232.0	1,848.0
Netherlands	37.1	25	6	230.0	1,699.2
Austria	38.8	25*	12	287.1	1,730.5
Poland	40.0	20*	9	232.0	1,848.0
Portugal	38.9	22*	10	249.0	1,773.8
Sweden	37.3	25*	9	253.6	1,686.0
UK	37.6	24.7	9	253.4	1,701.8
EU-28	38.1	25.3	9.8	267.3	1,711.9
Euro Area -15	37.6	26.7	9.9	275.0	1,677.9

Source: European Industrial Relations Observatory (2013), *Developments in agreed working time 2012.*
*Statutory minimum paid annual leave

A similar pattern emerges when we take a closer look at the working time during the entire year in Greece, excluding days off work, for leave and national holidays (Table 1). The working week agreed in collective negotiations between employers and employees in Greece is 40-hours long, which is the longest working week in the European Union (a number of other countries, mostly in Eastern Europe, also have a 40-hour working week). At the same time, the statutory minimum paid annual leave in Greece is 23 days per year, well below the EU and Eurozone averages (25.3 and 26.7 days respectively) and the Greek national holidays are slightly below the European averages. The result is that Greeks work on average 1,824 hours per year, or 125 more hours than the Dutch, 165 more hours than the Germans and 250 more hours than the French do.

On the skills front, the data again does not confirm the perception that Greeks are unskilled. More than 63% of young people between 15-24 years old participate in education (Figure 2). This is higher than the EU average, which stands at 61%, and higher than that in countries like France (58.4%), Austria (55.5%) and the UK (50.9%).

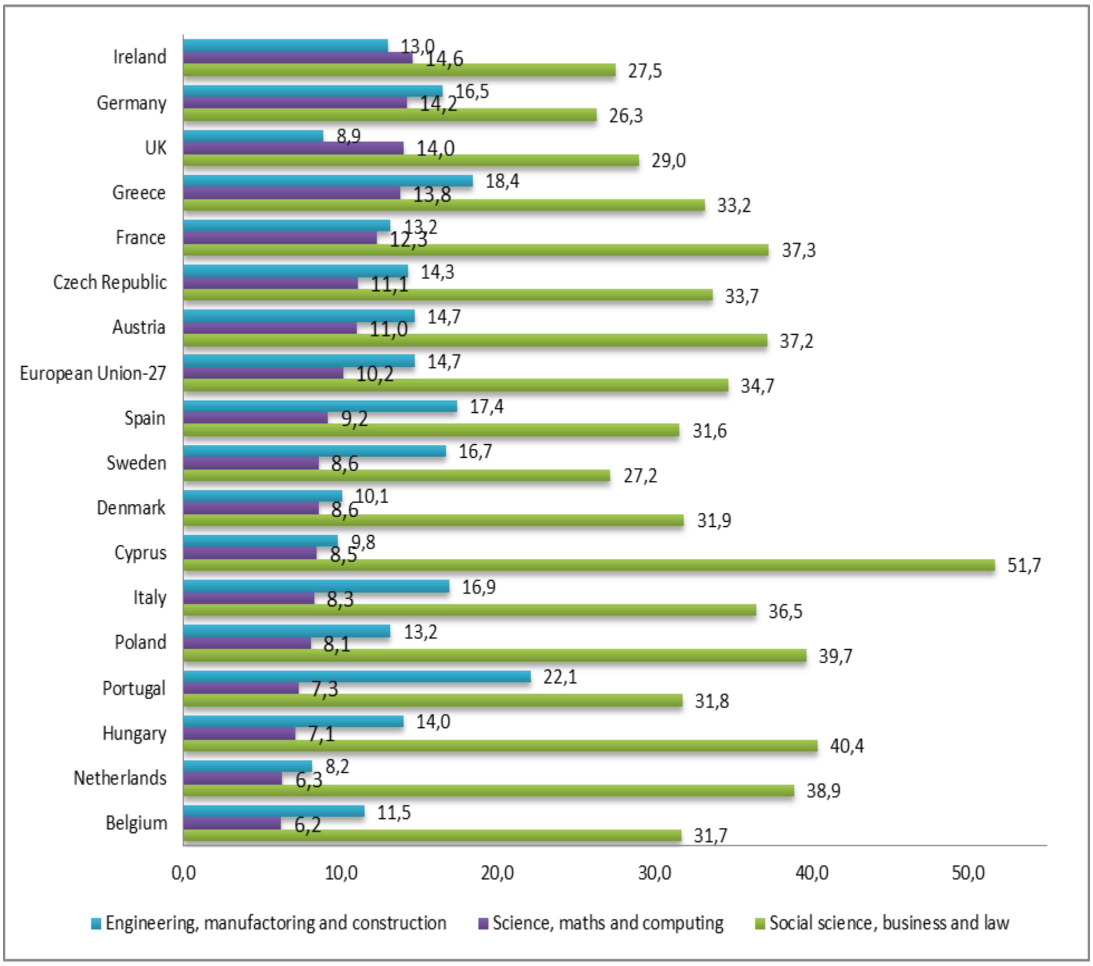
Figure 2. Participation rates in education
(2010, Students (ISCED 1-6) 15-24 years old as % of corresponding age population)



Source: Eurostat

Furthermore, Greek university students seem to display a significant proclivity towards mathematics and applied sciences (engineering, computing, etc.), fields that are generally considered crucial both for the productive capacity of the country, as well as for the growth of innovative and technology-driven high value added sectors (figure 3).

Figure 3. Students enrolled by field of education (2010, tertiary level as % of total)

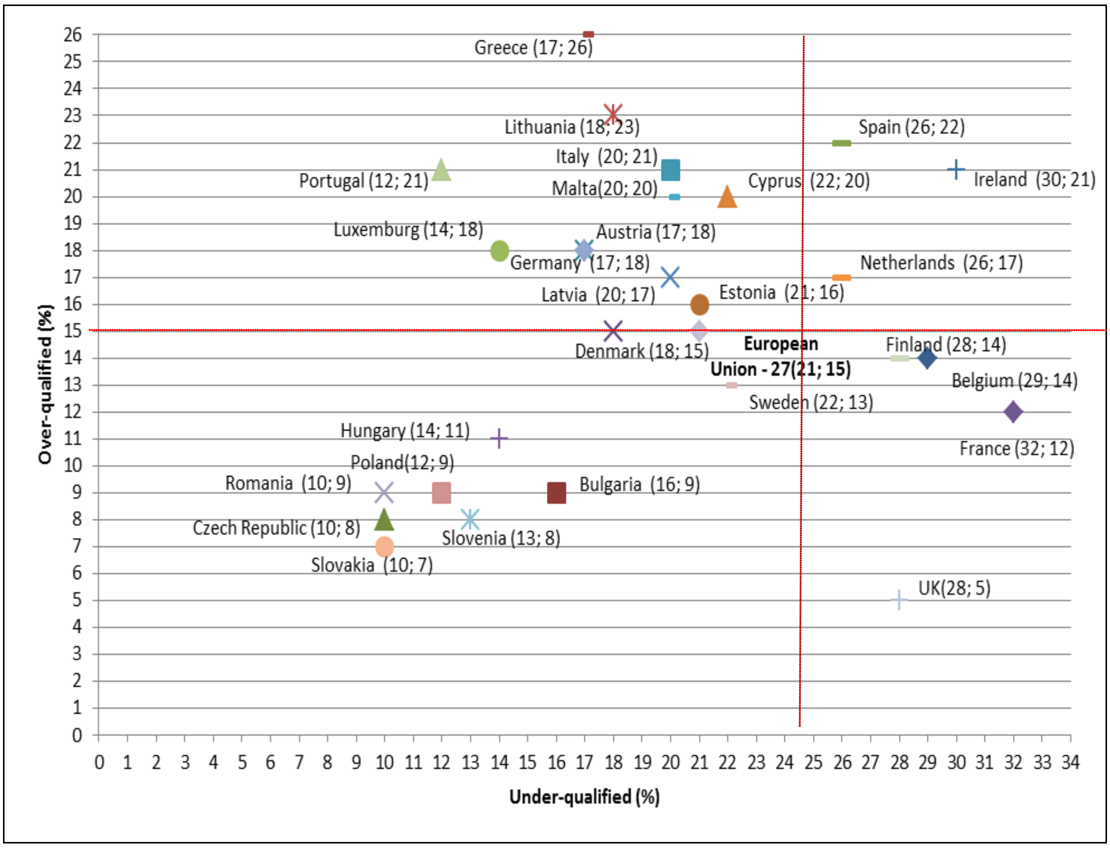


Source: European Commission (2012), *Education and Training Monitor 2012,* SWD (2012) 373 final.

The fact that Greeks are not short of skills, is also corroborated by data from the European Employment and Social Development Review 2012, which demonstrates that Greece has the highest level of over-qualified employees in the EU (Figure 4). The percentage of overqualified employees in Greece is 26% of the total number of employees, well above the EU average, which stands at only 15%. A similar trend emerges when we focus on more specific skills (as opposed to the qualification criterion, which refers mainly to the educational level), where again Greece has the second highest level of overskilled employees in the EU -more than 45% of its employees[1].

[1]European Commission (2012), Employment and Social Developments in Europe 2012, Brussels, pp.366.

Figure 4. Average Incidence of educational mismatch
(% of employees, 2001-2011)



Source: European Commission (2012), *Employment and Social Developments in Europe* 2012, Brussels.

A different kind of problem

The criticism that Greeks are "lazy and unskilled" is not supported by the data. Greeks work on average more than most other Europeans and have an educational and skills level, on par with workers in most other European countries. Therefore, the real question in the case of Greece seems to be why, given the high level of qualifications and long working hours, competitiveness has been low for many years. Obviously, a comprehensive answer to this question is beyond the scope of this paper, however, indicatively, we could say that one of the most significant factors for Greek economy's low competitiveness has been the high unit labor cost, which is the nominal compensation per employee, adjusted for labor productivity. In Greece between 2001 and 2007, the nominal compensation per employee rose by 41.3% and labor productivity by 17.2%. During the same period, the cumulative growth of compensation per employee in the European Union was 20.2% while labor productivity grew by 9.6%[2]. The mismatch between compensation and productivity is affected by structural characteristics of the Greek economy such as the fact that employment in the private sector is concentrated in small and medium-sized

[2]European Commission (2012), Employment and Social Developments in Europe 2012, Brussels, pp. 300-303.

enterprises and family-owned businesses, which produce non-tradable goods and services. The small scale of businesses, the low capital formation based on domestic private investment and product market regulation prevent the increase of labor productivity and create barriers to the diffusion of new technology and innovation. Finally, the skills' mismatch, which was demonstrated previously, also affects competitiveness, by way of the ineffective use of human recourses. The mismatch itself is once again the result of structural and institutional factors such as the absence of linkage between the educational and training systems and the labor market, the low employment turnover and the information asymmetry between employers and employees.

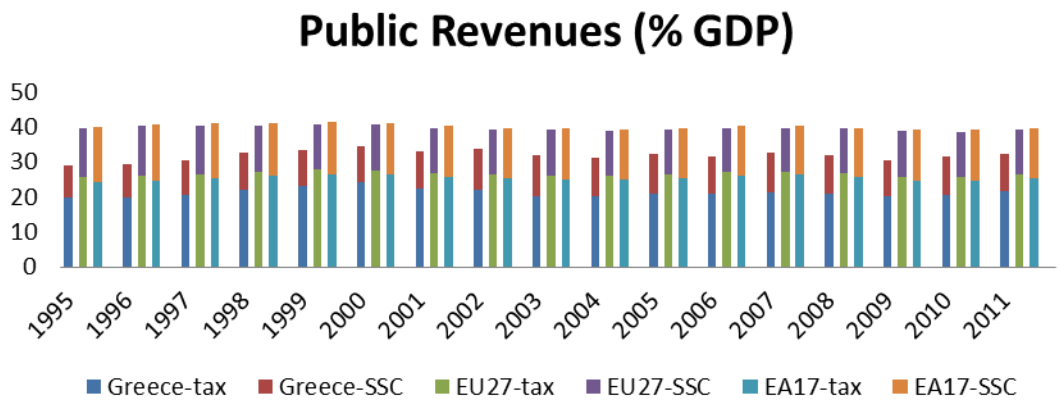
“Greeks don’t pay taxes”

Marianthi Anastasatou
Economist, Greek Council of Economic Advisors and Research Associate, Crisis Observatory (ELIAMEP)

A problem of low public revenues

“Greeks don’t pay taxes” is a statement so frequently articulated by prominent political figures and in the media that it has created a very powerful –and very negative- stereotype. But is this the case? Numbers may consist of hard evidence but their interpretation depends on the question asked. The analysis which follows attempts to show to what extent the above statement hides specific issues and characteristics of the Greek economy.

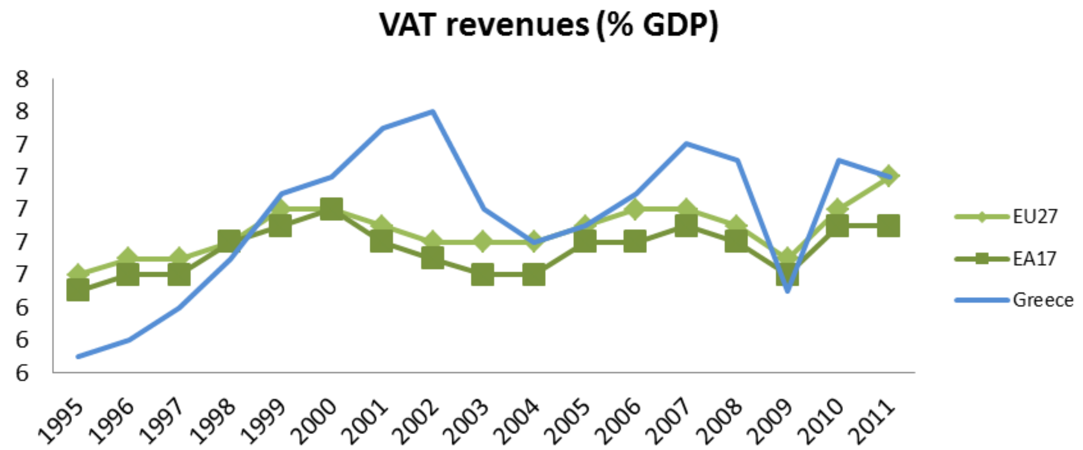
Greece’s public revenues indeed lag behind those of most European Union (EU) countries. According to Eurostat, during the period 1995-2011, the average total receipts from taxes were 21.3% of GDP in Greece, versus an EU-27 average of 26.6% of GDP. For the same period, total receipts from taxes and social security contributions (SSC) were 31.9% of GDP in Greece against an EU-27 and Euro-Area (EA-17) average of 40% of GDP. Based on these numbers, Greece ranks in the 20th position among EU member-states (including SSC) or in the 21st position (excluding SSC).

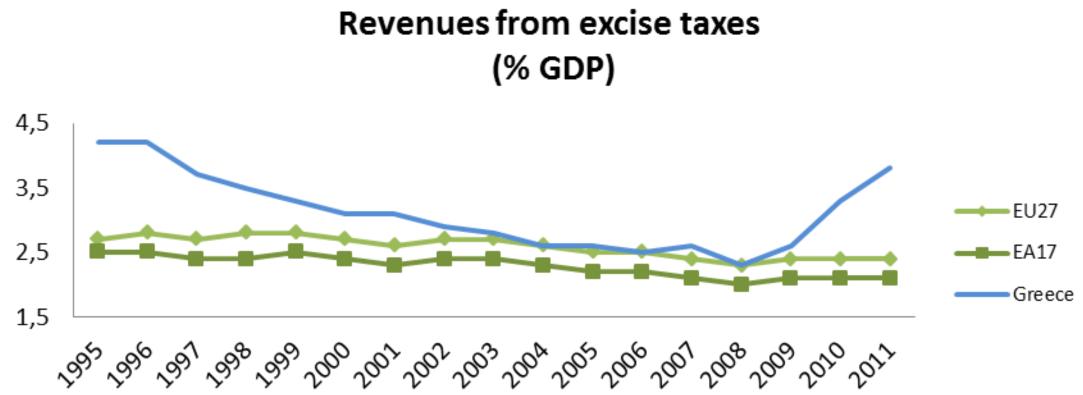


Source: Eurostat

Taxation in Greece

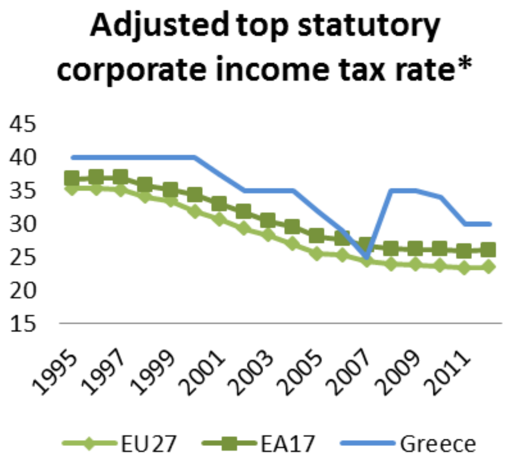
In order to identify where the problem lies, a further examination of the decomposition of revenues by different types of taxation is needed. According to “Taxation trends in the European Union”, the tax burden in Greece is biased towards indirect taxes, which account for 40% of the total taxation in Greece and 34%, on average, in the EU-27 for the period 1995-2011. This is an issue by itself, as indirect taxation implies an unfair distribution of the total tax burden among Greek citizens. In addition, indirect taxes disturb the allocation of resources and affect motives of economic agents. However, indirect taxes are more readily collectible and at present, they also contribute to the goal of the adjustment programme of the Greek economy to contain private consumption.

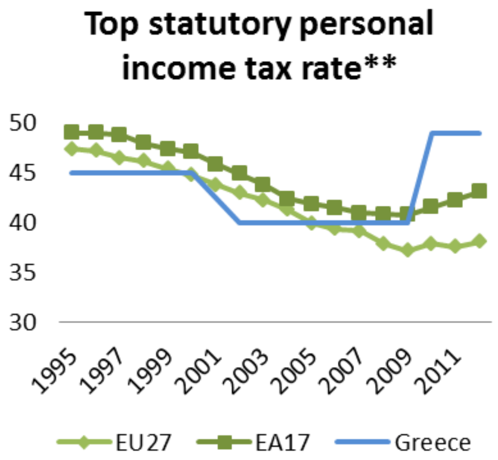




Source: Eurostat

Looking at the two biggest types of indirect taxation, i.e. VAT taxes and excise taxes, it becomes evident that Greeks pay an equal or higher share of indirect taxes in GDP compared to their EU partners. For the period 1995-2011 the revenues from VAT taxes were on average 7% of GDP in Greece, higher than those in the EU-27 (6,9% of GDP on average) and EA-17 (6.8% of GDP on average). Similarly, for the same period, revenues from excise taxes were 3.1% of GDP in Greece, 2.6% of GDP in the EU-27 and 2.3% of GDP in the EA-17.





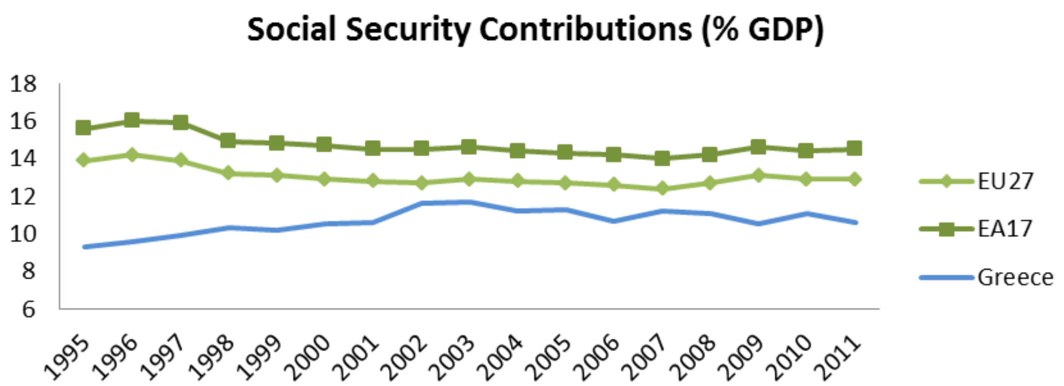
Source: Taxation trends in the European Union, Eurostat Statistical Books, 2012

* The tax rate refers to the “basic” (non-targeted) top rate including existing surcharges and averages of local taxes. Thus, in case of Greece, the special contribution introduced in 2009 is also included.

** The tax rates include existing surcharges and averages of local taxes. Thus, in case of Greece, the solidarity contribution introduced in 2011 is also included.

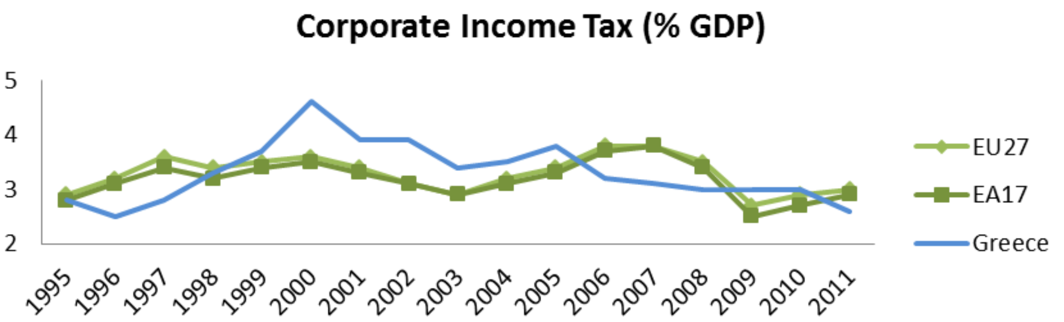
The above analysis suggests that the poor performance of Greece in terms of revenues is related to direct taxation i.e. with corporate income taxation (CIT) and personal income taxation (PIT). To further investigate this, the tax and SSC rates and the respective revenues are been considered next.

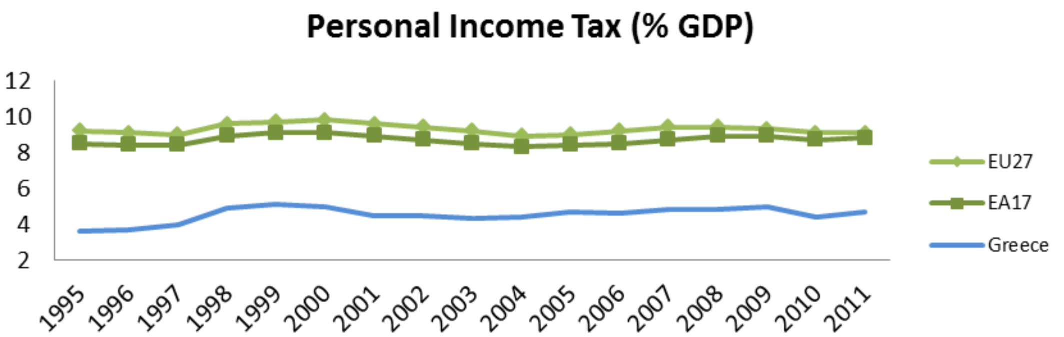
Regarding CIT rates, Greece in 2012 had the sixth highest adjusted top statutory tax rate in the EU27 and has traditionally been using one of highest top rates for most of the 1995-2012 period. Similarly, the top PIT rate in Greece is the eighth highest in the EU27. Furthermore, OECD’s “Taxing wages” data suggests that for 2012 the average tax rate in Greece is below the OECD average whereas the average tax wedge – i.e. income tax and SSC- is among the highest in the OECD. Thus, two conclusions emerge. First, Greece is characterised by a bias towards SSC rather than personal income taxation compared to other OECD countries and, second, the average taxpayer in Greece is not taxed as heavily as in other OECD countries, but the rates for the higher incomes are relatively more redistributive.



Source: Eurostat

Regarding public revenues from income taxation, Greece underperforms its EU peers in receipts from social contributions as a percentage of GDP but the share of revenues accruing from CIT is in line with EU partners. However, the picture is very disappointing for PIT revenues. During the past fifteen years, the revenues from PIT are substantially lower in Greece compared to the EU-27 average. More specifically, for the period 1995-2011, the (average) revenues from PIT were 4.5% of GDP in Greece compared to 9.3 % of GDP in EU.





Source: Eurostat

Do Greeks pay taxes?

The above analysis suggests that the problem is mainly in the area of personal income taxation. Although it is beyond the scope of the present article to examine the extent to which low tax revenues result from erroneous rates or poor compliance, the literature suggests that personal income tax evasion is indeed an issue in Greece, though at different degrees at various points of the income distribution or different professional groups. [1, 2]

Do Greeks have a genetic predisposition to tax evade? Apparently not. Arguably, there is less scope for tax evasion among employees and pensioners. However, all countries face a bigger challenge when it comes to the tax compliance of the self-employed. In Greece, an unusually

[1] A caveat needs to be added regarding the relatively low ranking of Greece regarding the average PIT rate. This fact doesn't necessarily imply that the rate needs to be increased. The extent to which some taxpayers evade taxes allows them to benefit from tax exemptions and low PIT rates imposed on low income brackets, thus impacting negatively the public revenues.

[2] See, among others, Artavanis et al (2012), Buehn and Schneider (2012), Matsagkanis and Flevotomou (2010).

high share of the labour force is self-employed.[3] This is partly due to the “I want to be the boss of myself” culture in Greece, but low tax enforcement surely also encourages Greeks to be self-employed. What needs to be underlined is that the relatively big share of self-employed in Greece is also related to a special characteristic of the Greek economy, namely that of the big and fragmented agricultural sector and the small lot related to historical developments.[4]

So, do Greeks pay taxes? Some pay a lot, maybe more than they should in view of the high top personal income tax rates, the relatively high social security contribution tax rates and the plethora of indirect taxes. Some don’t pay enough. Besides, it isn’t necessarily only the wealthy who tax evade.[5] It is not the DNA of Greeks that we should be looking at, but instead factors such as bureaucracy and the capacity constraints of the tax administration; the complex legislation and the sophisticated types of fraud that all EU members suffer from (e.g. carousel fraud). But it is also the structure of the Greek economy that potentially allows for the occurrence of more incidents of tax evasion compared to other countries. The sweeping structural reforms currently being implemented in Greece, such as the reform of the tax administration including a semi-autonomous secretary general for public revenues, new IT systems interconnecting tax offices, audits according to risk-based analysis, use of indirect audit methods, reforms in the taxation of farmers and other self-employed and reforms in all fronts aiming at cutting down red tape, aspire to address these problems.

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Matsaganis, M. and M. Flevotomou (2010), “Distributional implications of income tax evasion in Greece”, GreeSE Paper No 31, Hellenic Observatory, London School of Economics.

[3] Labour force survey data suggest that the self-employed in Greece are about double the EU or EA average, ranging between 35% to 30% of total employment over the last fifteen years compared to 15% in EU and EA on average.

[4] Eurostat’s labor force data suggest that in early 90s’ the share of the employment in the agricultural sector in Greece was about 20% of total employment, i.e. about four times bigger than the EU average (5.5%) and much higher than in other southern European countries e.g. Italy (7%), Spain (9%), Portugal (11%). However, this share has been decreasing fast and has almost halved during the last two decades, though it is still twice as high as the EU average.

[5] See, among others, Matsagkanis and Flevotomou (2010).

“Greeks are Selfish”

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A selfish society?

When asked in 2002 whether they tend to trust other people on a scale of 0.0-10.0, where 0.0 stands for no trust at all and 10.0 for very high trust, Greeks scored 3.6 (EU average: 5.0). When the same question was repeated in 2009, Greeks again scored a low 3.9 (EU average: 4.9).[1]

The World Giving Index, compiled by the UK-based Charities Aid Foundation and published in December 2012, shows that in 2011 only 5% of Greeks donated money to charities. An even lower share (3%) volunteered time to charitable activities. This performance puts Greece very close to the bottom of the list of 146 surveyed countries, on a par with Albania, Georgia, Montenegro and Sub-Saharan African countries.[2]
With regard to voluntarism, Greece is lagging behind other European Union (EU) societies. In a survey conducted in mid-2011, only 14% of Greeks replied that they had participated in a voluntary activity regularly or occasionally (EU average: 24%)[3]. It seems then that Greek society was permeated in the decade of the 2000s by distrust and suspicion to a larger extent than other EU Member-States societies; this did not seem to change in the wake of the economic crisis which hit Greece in 2010.

Yet, a closer observation of how Greeks have collectively responded to the acute economic crisis, which has resulted in dramatic decreases in wages, pensions and social transfers, may lead to different conclusions.

The social effects of the economic crisis

As it is well known, the Greek state has been undergoing an acute fiscal crisis for the past three years. The bailout agreement signed between the Greek government and the ‘troika’ of the IMF, the EC and the ECB in May 2010, resulted in extensive wage and salary cuts first in the civil service and then from February 2012 onwards in the private sector and the state-owned enterprises. Excess personnel working in state schools, hospitals and social services without tenure was laid off. The drop in available income affected demand negatively and economic depression followed. The unemployment rate, which in 2008 stood at 8%, in late

[1] See http://www.ekke.gr/html/gr/NewsEvents/ESS4_results.pdf, Annex, Tables 1 and 2, pages 28-29.
[2] See http://www.cafonline.org/PDF/WorldGivingIndex2012WEB.pdf.
[3] See Special Eurobarometer 75.2, http://www.europarl.europa.eu/pdf/eurobarometre/2011/juillet/04_07/ rapport_%20eb75_2_%20benevolat_en.pdf).

2012 reached 26 %. At the same time, youth unemployment (18-24 age group) exceeded 55 %, while thousands of small and medium businesses went bankrupt.

The duration of unemployment benefits in Greece is twelve months and the benefit is 360 Euros per month, which does not allow for a decent standard of living. What is worse is the low benefit take-up rate: only 17% of the unemployed are eligible to receive this benefit, while the rest are excluded, either because they have used it up or because they are otherwise ineligible to collect it.

Moreover, the nominal compensation per employee decreased by 13% in three years (2010-2012). However, in comparison with the pre-crisis period, the cost of living in major Greek cities has not decreased proportionately to the decrease in incomes. As a consequence, the demand for social services, including social assistance and health care has risen, but the state has been unable to meet the increased demand. Therefore, the state has started retreating from its role as welfare provider.

Social solidarity in the wake of the crisis

In the wake of this crisis, church organizations and private businesses reacted by trying to mobilize citizens to volunteer, not so much time or money, as goods, including food, clothes and medicines. For instance, in 2011-2012, a network consisting of the Greek Orthodox Church, the Armed Forces, the Greek radio channel SKAI and many super market chains collected food and clothes for distribution to the poor in the area of Athens. This drive was very popular and continues to be so to this date. The Church organized soup kitchens and collected goods offered by individual citizens, which it then distributed to the poor.

In addition, Greek civil society stepped in to cover for the gaps in social protection left by the retreating state. The mobilization of civil society included charity activities by NGOs and also informal networks and groups of citizens, working at the local level (neighborhoods, villages).

The mobilization of informal groups in the exchange and distribution of basic consumer goods

Informal social solidarity groups emerged through electronic media (websites, blogs and social media) or through local initiatives (announcements in the local press, posters put up in neighborhoods). While there is still no comprehensive data on the number, size, geographical origin and type of activity of these groups and networks, they appear to be scattered all over Greece. On-going research by ELIAMEP has shown that in 2012 social solidarity groups of this type could be found in 17 cities.[4] Such groups were involved in exchanges of consumer goods among their members and distribution of goods to persons in need. Town councils also mobilized citizens by setting up municipally-based 'social grocery

[4] Field research for this study was carried out by D. Bourikos, G.. Gleoudi, Nt. Karydi and M. Vellianiti, Athens, Winter 2012-2013.

stores'. Typically, the mayor of a city would provide some space in the town hall, while citizens and private companies contributed canned food and other foodstuffs.

Moreover, between November 2010 and January 2012, informal groups emerged in the Athens metropolitan area, which collected food and gave it to NGOs catering to the poor or directly distributed food left over at restaurants or households. Volunteers joined informal groups and NGOs focusing on the provision of basic services to the homeless, such as temporary shelters, food, blankets and medicine.

The provision of health care by NGOs and informal groups

Before the economic crisis, migrant children and ill persons from the migrant and refugee communities were taken care of by NGOs providing health services. These were annex organizations of large international NGOs such as 'Doctors without Borders' and 'Doctors of the World'. After mid-2010, the same organizations reported a change in the profile of their patients. Now, not only migrants but also native Greeks resorted to their medical services, as health care in public hospitals started crumbling down, while primary health care remained rudimentary.

With the help of town councils, which usually provided the necessary office space, informal groups of physicians started practicing medicine together in small collaborative medical practices. They received and treated patients for free. The aforementioned on-going research by ELIAMEP has shown that in the end of 2012 there were 'social infirmaries' in 29 cities. Town councils also collected medicines. They counted on the voluntary help of pharmacists and organized 'social pharmacies' in the headquarters of municipalities. In late 2012, there were 'social pharmacies' in 14 cities, dispensing medicines to people in need.

However, the increased voluntary activity in health care may not suffice to counter deepening social problems, such as, for instance, the increasing numbers among drug users who have tested positive for HIV. The disintegration of social services, which before the crisis monitored drug users in city centers and the lack of resources, including needles and medicines, have created conditions favorable to the spread of HIV among vulnerable segments of the population.

Conclusion

In the span of the last three years, Greeks realized that the economic crisis was more acute than originally thought and would last much longer than they had hoped. They started organizing themselves and helping each other, in a manner, which could not have been predicted on the basis of the low, pre-crisis performance of Greek society on all counts of voluntarism and charity giving. The shift in the mentality and behavior of Greeks, with regard to voluntarism and charity-giving, was neither reported in official surveys nor was it immediately perceivable.

The mobilization of NGOs and informal groups and networks amounts to an emergence of a type of social solidarity, which older Greeks can recall witnessing only at times of war and natural disasters. The haphazard and uncoordinated nature of this civil society mobilization notwithstanding, one hopes that it will provide the seeds for better and stronger ties among the 'haves' and the 'have-nots' as well as for the emergence of a third sector able to sustain itself in the future.

“The Eastern Mediterranean is a Quiet Neighborhood and Greece’s Role is Unimportant”

Thanos Dokos,
Director-General, Hellenic Foundation for European & Foreign Policy (ELIAMEP)

A ‘GREXIT’ looks now significantly less probable than at any time during the last 24 months. Although ‘Grecovery’ may begin to describe the current situation, Greece retains, however, some of the characteristics of a fragile country and the risk of poltical and social instability cannot be completely discounted. Given the extremely fluid situation in Europe’s periphery, including the Arab revolts, the civil war in Syria, the coup d’état in Egypt, the tension with Iran, and concerns about the direction of Russian foreign policy in the new Putin era, one would be justified to ask whether Europe and the U.S. could afford the creation of a security vacuum and a “black hole” in this critical region by allowing Greece to become another factor of instability in the area.

A preliminary assessment of the impact of the crisis on Greek foreign policy would conclude that the country’s image, prestige and credibility have been dealt a serious blow and its influence both inside the EU but also in its neighborhood has been negatively affected. The economic means available for conducting foreign policy [both in terms of ‘traditional/conventional’ and economic diplomacy] have been substantially curtailed. The decision has been taken to significantly reduce defence expenditures and, in this context, Greece’s participation in international peacekeeping and other operations (ISAF/Afghanistan, KFOR/Kosovo, Active Endeavour and Operation Ocean Shield (the naval operation to combat piracy in the Red Sea) have already been trimmed down. However, Greek facilities are being offered for use in NATO operations in the Eastern Mediterranean, although the benefits of Greek membership are sub-optimal both for the country and the Alliance. Perhaps the only positive foreign policy development in the last 2-3 years has been the cultivation of strategic ties with Israel and the realistic prospects for a more visible footprint for Greece in the regional energy map.

However, Greece’s –temporarily- limited foreign policy capabilities and regional role should not be confused with the country’s geostrategic value. The purpose of this short paper is to challenge the argument that Greece is a country with limited strategic value. On the contrary, it can be argued that Greece remains important for the West’s geopolitical interests for five reasons:

I. Stability in the Western Balkans

Either as a party to a dispute, or as balancing actor between Albanian and Slavic populations in the Western Balkans, Greece can play an important stabilizing role in the region. Key issues include Greece's dispute with FYROM about the name issue (where a compromise solution is urgently needed but one-sided pressure to Athens would surely be counterproductive), the recognition of Kosovo and the future role of the so-called Albanian factor in Southeastern Europe. On the other hand, Greece's economic presence In the region remains very important.

II. Immigration flows

The management of immigration flows from the Middle East, Asia and Africa will remain an issue with important external and internal dimensions for several EU countries. However much one tries to de-securitize the migration question, relations between Europe and the Middle East or the West and Islam will also affect domestic stability in European countries with a substantial Muslim community. Greece is the EU's most sensitive external border (in fact, playing the role of a 'buffer country") in the context of immigration. It is estimated that 90% of illegal immigrants entering the EU area each year do so through Greece and are required to remain there according to the provisions of the Dublin II Agreement (a trend that has been continuing for several years bringing the total number of illegal immigrants in Greece to unbearably high levels). Although there is no yet proof of any links between illegal migration and Islamic terrorism, the radicalization of societies in the Muslim world may constitute reasons for future concern.

III. European energy security

The question of European energy security has brought attention to the strategic significance of Southeastern Europe as a transport hub of natural gas and a key region for European energy security. To meet increasing natural gas demand and reduce high levels of energy dependency on Russia, European authorities need to promote the realization of projects contributing to the diversification of natural gas supply, alongside improving Europe's relationship with Russia by diversifying its import routes, two targets, which are not necessarily mutually exclusive.

In this context, the Southern Gas Corridor can play an important role. As the Trans-Adriatic Pipeline (TAP) –that will be crossing Greece and Albania on its way to Italy- was selected for the transportation of natural gas from Azerbaijan, it will provide a major boost for Greece's economy and regional role, as well as for regional cooperation in the Balkans (through interconnectors) and European energy security. In addition, Greece should be expected to try to enlarge its footprint in the energy map through other projects, in addition to the exploitation of potential hydrocarbon deposits in various parts of the country, notably in Western Greece and the maritime areas south of Crete. The East Med Gas Corridor, involving Greece, Cyprus, Israel and, perhaps, Lebanon is another interesting idea. Turkey could also be included, were it to adopt a substantially more constructive approach on the Cyprus problem.

IV. Vulnerability to non-western great power penetration

Following the example of its European partners, Greece is exploring available opportunities for improving economic and political relations with existing and emerging [non-western] powers, the so-called BRICS. Especially Russia and China are demonstrating a strong interest in Greece's energy and transport infrastructure sectors. In the latter case, Greece could become an economic gateway for China in Southeastern and Central Europe. It is hoped that Greek-Chinese political relations will continue to develop in a balanced way. Also, a balanced evolution of Greek-Russian economic and political cooperation might allow Greece to become a complementary "bridge" between the West and Russia, working quietly to assist in the full normalization of relations and the development of a strategic partnership within the emerging international system.

V. The Eastern Mediterranean conundrum

The Eastern Mediterranean and its adjoining regions remain an extremely turbulent and unstable neighborhood. In addition to the brutal civil war in Syria, with potentially destructive consequences for the whole region, there is considerable uncertainty about future developments regarding, among other, the political situation in Egypt, the Palestinian problem, the Iranian nuclear program, the role of Islamic parties in several regional countries, the Cyprus problem, domestic political developments in Turkey and Ankara's often unpredictable foreign policy and the discovery of substantial hydrocarbon deposits in the Eastern Mediterranean.

The understandable reluctance of the U.S. and EU to participate in a military intervention in Syria and the more general trend for an increased U.S. presence ('pivot') in the Asia-Pacific region make the need of active regional partners and allies in the Eastern Mediterranean even more crucial. In view of the inherent limitations in the Turkish-Israeli rapprochement, also as a result of Turkish own regional ambitions, the U.S. needs additional partners that would be acceptable interlocutors to the parties involved in various regional conflicts. In addition to its geostrategic location and the offered facilities (especially Souda Bay, arguably the most important –and dependable- Allied military facility in the Eastern Mediterranean), Greece –a traditional U.S. ally-- has what could be described as a privileged relationship –of various degrees- with Israel, the Arab world, Iran, Russia and China and could play, under specific conditions, the role of an additional pathway, while continuing to be a reliable regional partner.

Greek foreign policy needs to re-adjust to a changing regional and global security and economic environment and make a contribution to the national effort to re-build the economy. It needs to achieve that goal with limited resources and under time pressure. A "new Greece" would certainly be a useful partner for the EU, but also for the US and NATO, in regions of critical importance for European and transatlantic security and interests. Of course, Greek political leaders should step up to the challenge and seize the opportunities opening to thems.

“Cyprus Pays for Its Own Failures”

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University of Cyprus

An untimely experiment

In March 2013 Cyprus became the fourth Eurozone country to receive a rescue package from the troika of international lenders. It was perhaps the most controversial of the four agreements because of the “bail-in” element: for the first time, depositor money was to be used to recapitalize banks in trouble. The idea had been quietly discussed in policy circles for many months but its actual implementation in Cyprus came as a surprise to most and caused a stir. The inclusion of secured depositors in the original haircut decision was indeed a stunning outcome that has been subject to serious criticism.

The economic principle behind the bail-in is sound. Rather than being bailed out with state (taxpayer) support, ailing banks must self-finance their capital shortfalls by bailing in bondholders and – if necessary – depositors. This is a move in the right direction, yet there are several reasons why March 15, 2013 was not the right time to begin implementing it:

1. A formal framework for bail-ins did not exist at the time and the decision was applied in Cyprus in a haphazard and improvised manner. For example, there was no distinction between long-term deposits earning high returns and short-term deposits in current accounts. As a result, many companies lost large chunks of their working capital, leading to severe liquidity problems in the daily functioning of the economy. At least, we seem to have learned our lesson: the draft EU directive agreed upon in June has explicit provisions to protect small businesses.
2. Rules must be clear ahead of time. People who deposited their money at the banks were not aware that a bail-in was a policy option.
3. The bail-in was applied to Cyprus’ two systemic banks and effectively decimated the country’s banking sector.
4. Cypriot banks are deposit-based and had very few outstanding bonds. As a result, the burden fell almost exclusively on unsuspecting depositors.
5. There was no prior assessment of the impact of the bail-in on the Cyprus economy.

The economic consequences of the bail-in are nothing short of catastrophic. Total depositor losses have been estimated at around €8.3 billion, or 46% of GDP (€17.9 billion in 2012). The financial and business services sector that had been the most important growth engine for the Cypriot economy for the last several years has been crippled and there is nothing on the horizon to pick up the slack. It may take years to rebuild the image and credibility of Cyprus and develop new export sectors. The decision to shrink the banking sector to half its size overnight has resulted in a liquidity crunch that will stifle growth prospects for the short to medium term. Most analysts expect a contraction of 20-25% over the next three years. Unemployment was already at 15% prior to the haircut and is bound to rise well above 20%.

Did Cyprus really deserve this? Why was such a blunt and untested instrument used with little apparent regard for its tremendous social cost? Was there no alternative path that would provide Cyprus with the necessary support in a manner consistent with EU principles but without causing so much social disruption?

Ring-fencing Greece

Europe should have shown more solidarity towards Cyprus. It could have recognized the fact that the economic woes of Cyprus were to a large extent due to Europe's poor handling of the Greek crisis, including the mistimed haircut of Greek government bonds that cost Cypriot banks €4.5 billion (25% of GDP). The prolonged recession in Greece hurt Cypriot banks even more as they had extensive operations in Greece. Cypriot banks in Greece were in effect Greek banks, one of them being actually managed by a Greek group. It would have been justified to make provisions for capitalizing the Greek operations of Cypriot banks the same way that Greek banks were capitalized after the losses they took as a result of the Greek haircut.

On the contrary, Cyprus was doubly penalized. When the depositor bail-in was put on the table, the troika insisted that deposits in Cypriot banks in Greece should be exempt. The intent was clear. After a long and painful slog, the Greek economy was finally beginning to turn around. The last thing the troika wanted was to see the Greek banking system implode as a result of the bail-in of Cypriot banks. Thus, the solution adopted was to exempt Greek deposits from the haircut. It may have protected Greece but at the expense of depositors in Cyprus. Furthermore, the troika insisted that Greek operations of Cypriot banks be sold off to Greek banks, thus leading to an indirect transfer on top of the big losses already incurred because of the crisis in Greece. Thus in trying to save Greece and also cut off any transmission mechanism to the rest of the Eurozone, Europe decided to offload the cost to Cyprus – and many people think it is rather unfair.

A faulty model?

Many people have criticized the existence within Europe of low-tax jurisdictions, such as Cyprus, that serve as financial and business centers. Germany in particular has long been in favor of tax harmonization across Europe. The German finance minister, Wolfgang Schäuble, stated on several occasions that Cyprus model had failed and the country needed to chart a new course, while French finance minister, Pierre Moscovici, went so far as to call Cyprus "a casino economy".

What exactly was the Cypriot business model? In the aftermath of the Turkish invasion that devastated the island's economy, Cyprus decided to fashion itself as a financial and business center. The main attraction was a low corporate tax rate for international businesses,

complemented by a good location and climate, a common law-based legal framework and the high quality services provided by UK-educated accountants and lawyers. This was highly successful and the sector became the most important growth engine, especially after Cyprus joined the EU in 2004. This growth was accompanied by a large expansion of the banking sector to nine times GDP in 2009. The rapid expansion of the banking sector caused problems. Armed with plentiful liquidity, the banks financed business and consumer loans, a construction boom in Cyprus and rapid expansion abroad, especially in Greece, where they created extensive branch networks and invested in government bonds. Ex-ante, the expansion abroad could have been part of a well-designed diversification strategy. Ex-post, it turned into a disaster as exposure to the Greek economy brought the banks to their knees.
Given the outcome, it is easy to concur with the conclusion that the model has failed (though it is still difficult to come to terms with the “casino economy” reference). But it is important to understand exactly where the failure lies. Cyprus failed in letting its banking sector get too large and expand too quickly and recklessly. This does not render the strategy of a country specializing in the provision of business services as a failure. For the last twenty years Cyprus has invested in building an infrastructure that is designed to serve the needs of the international business community. It has established itself as a place where one can receive high quality accounting, legal and other business services at competitive rates. Many other countries, including several European ones, have followed similar strategies. There is nothing legally or morally wrong with being a business center, as long as the rules are followed and the banks are kept under tight control.

Did Cyprus follow the rules? In the months leading up to the March 2013 decision, the German press painted a picture of Cyprus as a laundering center for the ill-gotten gains of Russian oligarchs. This created a negative political climate and provided the moral justification for the country’s harsh treatment. Is there any truth to these allegations? Cyprus had in fact acquired a bad reputation for money-laundering in the 1990s. But in preparing for EU accession, it completely revamped its regulatory framework to meet European standards. International organizations like Moneyval rated Cyprus equally high with many other European countries for its anti-money laundering (AML) procedures. A more in-depth investigation specially commissioned by the troika pointed out weaknesses in the implementation of AML procedures in Cyprus but did not uncover anything that would justify shutting down the country’s international business sector.

Cyprus is perhaps paying for old sins and for electoral brinksmanship in other countries. The irony is that by recapitalizing the Bank of Cyprus using depositor money, the Eurogroup has handed ownership of the bank to its big depositors - purportedly those same Russian oligarchs! In reality, the vast majority of Russians with money in Cyprus are said to be owners of small and medium sized businesses rather than oligarchs (should we call them polyarchs?), while big depositors include many Cypriot pension funds, provident funds, and 401k-type investment plans who saw their savings wiped out.

Too high a price

Cyprus has made many mistakes. It allowed its banking sector to get too large and to expand quickly and recklessly abroad. It indulged in a decade of over-borrowing and over-consumption. When the international crisis first hit in 2008, it failed to appreciate the extent of the possible repercussions. Even after the Greek debt restructuring, the Cypriot government seemed oblivious to the blatantly obvious and failed to take any meaningful corrective action.

It is now time to pay the bill for these mistakes. This is perfectly acceptable, except that the bill is unjustifiably high. Cyprus is not paying just for its own mistakes. It is paying for a series of policy mistakes committed by the EU over the handling of the debt crisis. It is paying for the fact that it is small and thus can serve both as a testing ground and as an example to other profligate countries. This may be an instructive tool and an effective disciplining approach, but it hardly abides by the principles of fairness and solidarity espoused by the European Union. As it watches yet another European country sink into depression, the EU needs to take a long, hard look in the mirror.