Political and Institutional Roots of the Greek Debt Crisis

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Abstract

Greece's recent financial or sovereign debt crisis has been the severest one in the Eurozone and raised multiple concerns about the future of the Euro as well as the functionality of the EU's mechanisms and institutions. Various deteriorated economic variables, such as large structural fiscal deficits that led to accumulated sovereign debt beyond the Greek government's fiscal means, the fall of Greece's significant shipping and tourism industries due to the global financial crisis of 2007-2010, and the relative decline of national competitiveness, have been cited as immediate causes of the crisis. This paper, informed by Public Choice economics, traces the roots of the Greek sovereign debt crisis within the country's external and domestic institutional & political contexts. Institutional environment determines the incentives and conditions of what is possible for self-serving politicians and bureaucrats. Governments can be self-serving and self-promoting and do not always promote the social welfare. Voters are also self-interested and choose candidates that serve their narrow group interests. In Greece's political and institutional contexts, Greek politicians acted according to their political interests and ignored the economy's long-term health. They granted rents to multiple rent-seeking interest groups in Greece rather than acting for the overall well-being of the country. They did not or could not adopt economic reforms and wise economic policies that could have prevented the crisis. In 1992, members of the EU signed the Maastricht Treaty, under which they pledged to limit their deficit spending and debt levels, but several members, including Greece, have failed to stay within the confines of the Maastricht criteria. The European monetary union has been created without a fiscal and banking union among the Eurozone countries. The EU's political and institutional contexts also permitted the adoption of unwise policies that are harmful for the county's economic health. Actions and decisions of these self interested actors within these political and institutional contexts made the country economically and financially vulnerable to the crisis.

Keywords: Greek Sovereign Debt Crisis, The European Monetary Union, Political & Institutional Causes of Financial Crises.

What is This Paper About?

The recent global financial crisis that started within the US housing market in 2007 reached Europe by 2008. It caused a "great recession," the worst one since the 1930s, in the US and the EU. Causes of the crisis varied by country in the EU. Some EU countries, such as Spain and the United Kingdom, had their own real estate bubbles that burst. Some European countries' financial institutions were heavily exposed to mortgage backed "toxic" assets and their banking systems faced extreme stress. When their governments, like that of Ireland[1], bailed out on their

[1] Ireland's debt-to-GDP ratio increased from 25% to near 100% mainly due to its government's bailing out of the country's banking system between in 2007-2008. See Federal Reserve Bank of St. Luis, the Sovereign Debt Crisis:

banking systems, their government deficits and debt grew hugely. Some other EU countries adopted fiscal stimulus and state aids for ailing industries, while tax revenues were plummeting. In Greece, continuous structural government deficits, connected to high public sector wage and pension commitments, resulted in high levels of debt-to-GDP ratios and the global crisis made the situation worse. The credit freeze that followed after the collapse of Lehman Brothers in 2008 not only affected banks and businesses in the US and EU, but also revealed the vulnerabilities of high debt-to-GDP ratio EU countries, such as Greece, Ireland, Portugal, Spain, and Italy --all in the Eurozone. The debate over the causes of the global, Eurozone, and Greek crises continues.

Financial crises are significant economic, political and international events. In recent decades, the world has experienced multiple financial crises such as the crisis of the European Monetary System (EMS) in 1992-1993, the Mexican Peso crisis of 1994-1995, the Asian financial crisis of 1997-1998, and the financial crisis in Argentine in 1999, and the global financial crisis of 2007-2010, the repercussions of which still continue. Historically, the origins, deeper causes, and consequences of the crisis varied. Financial crises start with sharp breaks in the prices of key financial instruments,[2] as it happened in the US and in some European countries when mortgage-backed financial assets lost their values harshly. The quick decline of these asset prices changed the expectations of market participants suddenly and sent shock waves through markets as various investors and banks tried to adjust their positions rapidly. Repercussions of the financial crisis spread beyond the borders of affected countries due to globalization, the integration of financial markets, the network of economic linkages, and threatened regional and global economic stability. They not only endanger the economic stability of countries and stability of markets all around the world, but could also destabilize social orders within countries as well as domestic and international politics.

The Greek crisis, and the Eurozone crisis at large, raised multiple concerns about the future of the Euro as well as the functionality of the EU's mechanisms and institutions. Greece's sovereign debt crisis has been the severest one in the Eurozone. Various deteriorated macroeconomic variables, such as large structural budget deficits --nearly 13% of the country's GDP in 2009-- that led to accumulated sovereign debt beyond the Greek government's fiscal means, the fall of Greece's significant shipping and tourism industries due to the global financial crisis, and the relative decline of national competitiveness, have been cited as immediate causes of the crisis. Greece's debt-to-GDP ratio, which is an indicator of a country's ability to pay off its entire debt, went much over 100% and created fear about Greece's default.[3] After lenders and investors lost their confidence in the Greek government's ability to pay, the Greek government was no longer able to roll over or pay back its debt, due to its high budget deficits. Greece's debt crisis in Europe's single currency zone (Eurozone) created larger concerns about the collapse of the whole Eurozone, which could have led to a global financial catastrophe. There was a risk of

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A Modern Greek Tragedy. Central Banker | Summer 2012. http://www.stlouisfed.org/publications/cb/articles/?id=2264. Accessed July 5, 2014.

[2] Louis W. Pauly. Pauly, Louis W. "The political economy of global financial crises." In *Global Political Economy*. John Ravenhill,, ed. Oxford University Press, 2011), p. 249.

[3] Federal Reserve Bank of St. Luis, The Sovereign Debt Crisis: A Modern Greek Tragedy. Central Banker | Summer 2012. http://www.stlouisfed.org/publications/cb/articles/?id=2264. Accessed July 5, 2014.

contagion of the Greek crisis spreading to other troubled Eurozone countries, i.e. Ireland, Portugal, Spain, and Italy.

Even though deteriorated economic variables sparked the crisis in Greece, they do not explain why these economic variables deteriorated and why Greece was vulnerable enough to be affected by them. Of course, the same questions can be asked for Ireland, Portugal, Spain, and Italy, but this paper focuses on Greece. It aims at tracing the roots of the Greek financial crisis within the county's domestic as well as regional institutional and political contexts. In doing so, it benefits from Public Choice and Political Economy approaches.

This research argues that, along with economic factors, there were deeper political, institutional factors-- both internal and external to Greece— that made Greece vulnerable to the emergence of its debt crisis, and subsequently shaped the Greek government's handling of the crisis. The EU's and Greece's political and institutional contexts permitted Greek policy makers to adopt harmful economic policies that served their political interests. Greek politicians acted according to their political interests, i.e. for winning elections and gaining or maintaining political power, thus ignoring the economy's long-term health. The institutional environment determines the incentives and conditions of what is possible for self-serving politicians and bureaucrats. Voters are also self-interested and choose candidates that serve their narrow group interests.

How did the Global Financial Crisis Reach Vulnerable Greece?

On December 10, 1991, EU countries agreed on the Maastricht Treaty, setting an "irrevocable" monetary union that would start in 1999. The European monetary union (EMU) was created without a central finance ministry or a mechanism to leave the Euro. Until then, the EU countries used the Exchange Rate Mechanism (ERM), which was an adjustable peg system and a precursor to the monetary union. It was created to bring some stability to the exchange rate among the member countries. However, some member countries could not maintain the peg system. In September 1992, the U.K, followed by Italy, had to exit Europe's Exchange Rate Mechanism (ERM), due to speculations. Several EU member countries' currencies were devalued. In December 1996, a stability and growth pact that imposed penalties on countries that exceed deficit limits was agreed upon by EU leaders. Greece joined the ERM in March 1998. On January 1, 1999, the Euro was set with 11 founding members.[4]

In January of 2001, Greece dropped its currency, the drachma, adopted the Euro, and became the 12^{th} member of the Eurozone. As will be discussed more in detail in later parts of this paper, Greece was admitted to the Eurozone even though the country did not meet the criteria set by member countries with the Maastricht Treaty of 1992 and the Stability and Growth Pact of 1997 for becoming eligible to join the Euro. Greece had chronic budget deficits, and its debt-to-GDP ratio was higher than the amount set by the eligibility criteria. The country was expected to continue with its efforts to improve its economy, as expressed by then-ECB President, Win

[4] Bloomberg News. Greek Crisis Timeline from Maastricht Treaty to ECB Bond Buying. Sep 6, 2012. http://www.bloomberg.com/news/2012-09-05/greek-crisis-timeline-from-maastricht-treaty-to-ecb-bond-buying.html. Accessed on July 4 214.

Duisenberg. After joining the Eurozone, the country experienced a relatively high growth rate, averaging around 4% from 2000 to 2008.[5] However, the growth rates were misleading.

The Greek economy had various structural and chronic problems prior to the crisis, most significant of which were the budget and current accounts deficits. Its budget deficits averaged 5 percent of GDP and its current account deficits averaged 9 percent of GDP between 2000 and 2008, even though it is economic growth averaged 4 percent between those years. The economic growth was stimulated by cheap credit and strong consumption demand as well as the government spending for the preparation for the Olympic Games of 2004 in Athens. .[6] Greek governments have been spending beyond its means for a long time, even before it adopted the Euro. After Greece adopted the single currency, the country's spending soared based on borrowed money at a lower cost, mostly from outside the country. Thus, Greece, with its high budget and current account deficits, accumulated the highest level of public debt in the Eurozone. Much of the increased government spending went to public sector wages and pension payments. Greece's public sector wages rose 50% between 1999 and 2007, much faster than in most other Eurozone countries.[7]

The country's current account deficits were the results of its uncompetitive economy that exported less than it imported prior to the crisis. The increase of the country's current account deficit from about 6% to about 15% between 2004 and 2008, was an indicator of the decreasing competitiveness of the Greek economy. In fact, Greece had the least competitive economy among the 27 EU members before the crisis. Greece also ranked low globally (83rd), below countries such as Vietnam, Jordan, Iran, Kazakhstan, Namibia, and Bostwana, according to the Global Competitive Index of the World Economic Forum for 2010–2011. Moreover, Greece ranked low in terms of foreign direct investment (FDI) inflows, ranking 119th out of 141 countries, according to the 2011 World Investment Report by the United Nations Conference on Trade and Development.[8] Lower ranking in the FDI was related to the unfavorable business environment in Greece. Of course, less investment translates into a lower GDP and a higher unemployment rate. Thus low competitiveness and an unfavorable business environment have been other chronic problems in Greece.

Underlying structural issues in Greece as well as in a few other Eurozone countries increasingly became visible and unsustainable as the global financial crisis reached the EU. Troubles started to show up for high debt-to-GDP countries, including Greece, after September 15, 2008. On that date, Lehman Brothers, which was one of the major Wall Street firms, filed for bankruptcy, investor confidence shifted, and a worldwide market panic and a credit freeze followed. Already vulnerable Greece, due to its reliance on international capital markets for financing its deficits,

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[5]Pantelis Sklias and Georgios Maris. "The political dimension of the Greek financial crisis." Perspectives on European Politics and Society 14.1 (2013), p.148. Also see, The Telegraph, Timeline of a crisis: how Greece's tragedy unfolded. http://www.telegraph.co.uk/finance/economics/8580720/Timeline-of-a-crisis-how-Greeces-tragedy-unfolded.html. Accessed on July 4 2014.

[6] Thomas H. Oatley. International political economy. Boston: Longman, 2012. p. 245 and Manos Matsaganis. "The welfare state and the crisis: the case of Greece." Journal of European Social Policy 21.5 (2011), p.501.

[7] BBC News Business, "Eurozone crisis explained"... Also see Rebecca M. Nelson, Paul Belkin, and Derek E. Mix, 2010.p.1.

[8] Aristides N. Hatzis. "Greece as a Precautionary Tale of the Welfare State." *After the Welfare State edited by Tom G. Palmer, Atlas Economic Research Foundation, Washington, DC* (2012).

started to have difficulty rolling its debt and Greek government bond yields / interest rates started to rise. As investors' confidence in the Greek government's ability or willingness to repay its debt declined, Greece's bond yield rates continued to rise throughout 2009, which made borrowing from markets for repaying its existing debt forbiddingly costlier.[9] As a result, the Greek government had to adopt austerity measures quickly in order to get financial assistance from the EU countries and the IMF, or default on its debt. As will be discussed later, a Greek default could have been much more harmful to the country, to the Eurozone, and for global recovery.

By 2009, Greece's external debt reached to about 115% of GDP and the government budget deficit reached to almost 13 percent of GDP. As the country's government expenditures were rising and government revenues fell due to the global recession and declining tourism and shipping sectors, Greece's already vulnerable financial position became worse in 2009, as the Greek economy moved to a recession. The Panhellenic Socialist Movement (PASOK) government, elected in 2008, made it public in November 2009 that the previous Greek government manipulated its balance sheets to hide its debt. Thus, the 2008 deficit was corrected from 5% to 7.7% of GDP, which was later revised to 9.4% of GDP. The estimated budget deficit for 2009 was revised from 3.7 % to a much higher 12.5 percent of GDP, which was raised again to 15.4% of GDP later. The estimated public debt was raised from 99.6 % to 115.1 %, and later to 126.8% of GDP. The current account deficit also increased to 14.7% of GDP in 2008, which was a sign of the country's loss of competitiveness.[10] The announcement of these worse fiscal positions of the country sparked the Greek debt crisis by causing market participants to further lose their confidence. The Greek government was no longer able to roll over its debt without outside help. More economic data that shows Greece's vulnerabilities are presented in the next section.

Things started to get out of control as the rating agencies lowered Greek debt scores and the market's trust in the Greek government's ability to pay was shaken. Ireland followed Greece with its own sovereign debt crisis. Fitch cut Greek debt from A- to BBB+ in December 2009. Greece's announcement of a stability program in January 2010 to cut its deficit to 2.8 percent of GDP by 2012 did not help. Initially, in April 2010, Eurozone finance ministers approved a €30billion aid package for Greece. However, Greece needed much more than just this amount. On April 27, 2010, S&P also downgraded Greek debt to BB+, and later to junk bond status. This alarmed financial markets and the Greek stock market also crashed. As Greek government bond yields went so high, private capital markets were practically closed to the Greek government for borrowing.[11] The EU leaders needed to act soon. A Greek default could have led to a banking crisis in the EU, since many banks, especially those in France and Germany, had a high exposure to Greek debt. Of course, there was a danger of contagion to other highly indebted countries in the Eurozone.

[9] Rebecca M. Nelson, Paul Belkin, and Derek E. Mix. "Greece's debt crisis: Overview, policy responses, and implications." Library Of Congress Washington Dc Congressional Research Service, 2010.p.5, and Bloomberg News. Greek Crisis Timeline from Maastricht Treaty to ECB Bond Buying….

[10] Manos Matsaganis. "The welfare state and the crisis: the case of Greece." Journal of European Social Policy 21.5 (2011).P.501.

[11] The Telegraph, Timeline of a crisis: how Greece's tragedy unfolded… Also see, Bloomberg News. Greek Crisis Timeline from Maastricht Treaty to ECB Bond Buying...

During 2010, the Greek crisis worsened. In May 2010, the Euro-area countries agreed to provide €80 billion, and the IMF agreed to give €30 billion under a stand-by agreement, thus the total bailout package of €110bn was to be disbursed over three years. These loans were conditional on implementation of the austerity measures to restore the fiscal balance, privatization of government assets worth €50 billion by 2015, and following of structural programs to increase competitiveness and economic growth prospects. The EU, the ECB, and the IMF were referred to as the troika from May 2010 onward. The ECB supported Greece and other troubled Eurozone countries by announcing its bond buying programs (practically buying Greek debt) later. As the concerns intensified, EU leaders also agreed to install the Emergency Financial Stability Facility (EFSF), totaled €750bn, including a €30 billion line of credit from the IMF, in May 2010.[12]

As Greece started to receive installments of the bailout package, which enabled the country to repay its immediate debt, its parliament passed some austerity measures throughout 2010. Over the next three years €30billion in austerity cuts were required. After S&P and Moody's, Fitch also cut Greek debt to junk status in January 2011. Throughout 2011 as well, the Greek government was pushed for further budget cuts and privatization, through which the government was expected to raise €50bn by 2015. In the meantime, street protests in Greece were intensified, often turning violent. The EU finance ministers and political leaders continued with their discussion of restructuring Greek debt and a second bailout package in 2011.[13] In April 2011, the Portuguese government also requested EU bailout money, and about a month later, the EU approved a €78 billion bailout for Portugal on May 15. The Papandreou government announced a new €76 billion in austerity measures (increased to 78 billion euros later), which was supposed to be accomplished by the end of 2015. On July 21, 2011, EU leaders agreed on the second bailout package for Greece and expanded the powers of the EFSF. Due to public reactions to the austerity measures, Prime Minister George Papandreou first said that he would put the second bailout agreement on a referendum for public approval, but later, on November 3, 2011, he backed off from this. Subsequently, Greece faced a political crisis, which led to the resignation of Papandreou on November 6. A technocratic government of national unity under the premiership of Lucas Papademos, a former ECB vice president, was formed on November 11 and paved the way for the implementation of the new bailout. By the end of 2011, EU leaders tightened rules to curb future debts.[14]

In February 2012, euro-area finance ministers approved the second bailout package of €130 billion, prepared by the troika. It included a 53.5 percent write down or "haircut" for investors in Greek bonds and the program became active a month later. The writing down involved exchanging existing holdings for new, more liquid and secure bonds.[15] As a result, Greece's debt-to-GDP ratio also declined, then from a forecast of 198% in 2012 to about 160%. This bailout package was also conditional on the implementation of an additional austerity package as well as the continuation of structural reforms, labor market reforms, and privatization as outlined in the first program. The Greek parliament voted on austerity cuts needed for receiving the

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[12] The Telegraph, Timeline of a crisis: how Greece's tragedy unfolded… Also see, Bloomberg News. Greek Crisis Timeline from Maastricht Treaty to ECB Bond Buying. …

[13] The Telegraph, Timeline of a crisis: how Greece's tragedy unfolded....

[14] Bloomberg News. Greek Crisis Timeline from Maastricht Treaty to ECB Bond Buying. …

[15] Abraham Newman. The Greek Haircut and Europe's Shared Responsibility: Why Banks and Rich Countries Have to Pitch In…

disbursements of the bailed package on March 1, 2012. Even though the EU leaders declared the end of the financial crisis on May 2, the recession in Greece continued throughout 2014. Greece had a parliamentary election on May 6 and an anti-bailout / anti-austerity party Syriza finishing a surprise second to the New Democracy party, one of the major two parties of Greece. PASOK, another major party of Greece, lost big. The elections were repeated in June due to the failure of coalition talks. The New Democracy party led by Antonis Samaras, as the highest vote receiver of Greece's elections, formed a coalition government with the opposition PASOK party. The struggle between the Troika and the Greek government continued as the bailout disbursements were held on delays of implementation of the austerity measures. A more realistic new plan was negotiated in November 2012, which required Greece to bring its debt-to-GDP ratio to 124 percent by 2020, and "substantially below" 110 percent by 2022.[16] The IMF considers a 120% of debt-to-GDP ratio sustainable. Greece was supposed to achieve a 124% of debt-to-GDP ratio by "cutting the interest rate on existing rescue loans, returning profits earned by the European Central Bank on Greek debts it owns, and helping Greece buy back its private-sector debts at their currently depressed market prices. The plan did not involve any write-off of the bailout loans owed by Greece."[17] As the country's economic and fiscal challenges continued, Greece had another parliamentary election on January 25th, 2015, and this time Syriza won the majority and formed the government. The party came to power with a very populist and anti-bailout/ anti-austerity rhetoric. We are yet to see how Syriza's victory and the new government's actual policies will affect Greece's relations with the Troika and EU member countries. Nonetheless, after five years of recession, Greece still has a long way to go for its full economic recovery and fiscal soundness. Syriza's victory could be a setback in the process of structural reforms, if it follows the populist policies promised by the party during the elections.

Greece's Political and Institutional Contexts That Made the Country Vulnerable

Greece's deteriorated macroeconomic conditions explain why Greece was affected the way it was by the global financial and Eurozone crises. But, how did Greece's vulnerable economic/ fiscal conditions as described in the previous section come to existence, predisposing the country to the crisis? Even though the deteriorated economic/fiscal conditions were obvious before the start of the debt crisis in 2009, why did Greek governments not solve those problems? Why did they accumulate these problems and postpone reforms? Answering these questions requires us to reflect on the behavior of policy makers, political processes, and institutional contexts in which political actors/ decision makers behave.

This paper, informed by Public Choice economics, discusses the incentives and behaviors of "self-interested" political actors within institutional contexts. Institutions, as laws, norms, and principles, determine the rules of the game in a society and shape human interactions at large. They provide incentives and/ or constraints to self interested individuals, therefore affecting their decisions and actions. As Acemoglu and Robinson (2008, p. 1) believe, "institutions, also very

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[16] Bloomberg News. Greek Crisis Timeline from Maastricht Treaty to ECB Bond Buying. … Also see Christopher Alessi. The Eurozone in Crisis. April 3, 2013, Council on Foreign Relations http://www.cfr.org/eu/eurozone-crisis/p22055?cid=ppc-google-eurozone-eurozone_backgrounder&gclid=CPLK3s2GsLwCFTCCQgodBV4APg Accessed July 5, 2014

[17] BBC News Business, "Eurozone crisis explained."A27 November 2012. Accessed July 4, 2014. http://www.bbc.com/news/business-13798000

broadly construed, are the fundamental cause of economic growth and development differences across countries." [18]

As Public Choice economics informs, governments can be self-serving and self-promoting and cannot be ensured of promoting social welfare. We cannot assume that government is there to determine what was best for society and was eager to carry out this task. Therefore, constitutional designs and specific laws that create institutions are very important. Politicians and bureaucrats have their self interests that do not necessarily coincide with the interests of taxpayers at large with national interests. The institutional environment determines the incentives and conditions of what is possible for self-serving politicians and bureaucrats. Voters are also self-interested and choose candidates that serve their narrow group interests. Various voting rules affect individuals' voting incentives and aggregation to group decisions.[19]

With this pluralistic approach, voters, lobby groups, politicians, and public officials aim to maximize the policy outcomes that they personally desire, with a minimal cost to them individually. Different people have different values and different interests in the society. There is no single public interest. "Political decision-making is not a dispassionate pursuit of the 'public interest', but can involve a struggle between different personal and group interests…. This makes it vital to study how such competing interests and demands are resolved by the political process."[20] The self-interested political parties are interested in getting the votes in order to win power and position. They follow the strategies to get as many votes as possible within the political and ideological spectrum. Government officials may try to maximize their budget as long as the larger budget serves their own interests. Small but sharply focused and well organized interest groups may impact decision making processes more than much larger groups. Interest groups that gain larger benefits or have higher stakes in the political decision process and outcome will be willing to spend large sums on lobbying for special privileges (or for rent seeking) than those interest groups which do not have such high stakes. As a result, interest groups that represent smaller segments of the population may have a powerful influence in decision outcomes. Not only may minorities be exploited by the majority, but minorities may exploit majorities as well. How these competing interests are expressed, represented, and aggregated as well as their relative impact on policy decisions depends on the institutional context, including constitutional rules.[21]

Greece's Domestic Political and Institutional Contexts: How did they contribute to Deteriorated Economic Variables?

Greece won its independence from the Ottoman Empire in 1832, after a long war of independence that was initiated in 1821. The country, as a parliamentary monarchy, defaulted on its debt four times during the 19th century. Greece had a turbulent political transition to democracy during the 20th century. The country changed several kings, experiencing multiple coups or coup attempts before 1940. It had short-lived dictatorships from 1929 to 1936 and a

[18] Quoted in Pantelis Sklias and Georgios Maris. "The political dimension of the Greek financial crisis." Perspectives on European Politics and Society 14.1 (2013): 147.

[19] Jac C. Heckelman, *Readings in public choice economics*. University of Michgan Press, 2004, p.2.

[20] Eamonn Butler, "Public Choice-A Primer." *Institute of Economic Affairs Occasional Paper* 147 (2012), p. 15.

[21] Eamonn Butler, Public Choice – A Primer, p. 16, 17.

rightist dictatorship from 1936 to 1940. Greece was devastated by World War II and a subsequent civil war, involving the communist insurgency in the 1940s. The country was ruled by a "paternalistic illiberal democracy" from 1949 to 1967, and the military junta from 1967 to 1974. With a new constitution in 1974, Greece became a democracy and joined the EU (then the European Community) in 1981.[22]

Despite the dictatorships, wars, and insurgencies, Greece had remarkable economic growth rates, averaging 5.2 percent from 1929 to 1980. Unlike Greece's current situation, when it joined the EC/EU, its public debt-to-GDP ratio was just 28% and the government budget deficit was less than 3%. The economy was stable with low unemployment rates.[23] Before the crisis, the Greek economy had been growing with the infusion of increased EU funds since the 1980s. During the last 30 years prior to the crisis, despite the deterioration of some economic/ fiscal indicators, Greece was able to avoid any deep economic/ financial crisis. Of course, the huge supply of EC/EU financial aid, which was given with the goal of narrowing the gap between Greece and the more developed EU member states, helped Greece to stay afloat and improve its infrastructure. During the post-Cold War period, the growth of Greece's two big sectors, shipping and tourism, also contributed to Greece's economic growth. Greece's private sector benefited from the opening of the economies in the Balkans, and Greece's most competitive sector, shipping, benefited from worldwide trade liberalization and high growth in emerging markets like China, India, and Brazil. In the 1990s, Greece also benefited from the arrival of more than a million immigrants from southeastern Europe, the former Soviet Union, the Middle East, and the Indian subcontinent. The cheap labor coming to Greece gave a temporary boost to its competitiveness and revitalized the Greek economy. Thus, its economy, stimulated by those factors, enabled Greece's entry to the Eurozone and its adoption of the Euro as its currency.[24]

However, Greece's economic conditions were not sustainable, and its economy was mismanaged and public finances were misused. Various features of Greece's economic, political, and institutional contexts --among which are large government and current account deficits, large and inefficient public administration, pervasive state control and regulation of the economy (or statism), clientelism and endemic tax evasion did not allow Greece's positive economic trends to continue and created the conditions leading to the crisis. The influx of capital at low interest rates during the 2000s enabled Greek governments to finance their growing deficits, and the global financial crisis of 2008-2009 exacerbated Greece's structural and chronic problems.[25] The Greek debt crisis demonstrated how mismanagement of its economy and public finances can lead to an economic catastrophe.[26] Also, Greek political leaders within Greece's political and institutional contexts failed to address its fixable economic issues.

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[22] Aristides N. Hatzis. "Greece as a Precautionary Tale of the Welfare State." *After the Welfare State edited by Tom G. Palmer, Atlas Economic Research Foundation, Washington, DC* (2012). P. 22. Also see, Dante Roscini, Jonathan Schlefer, and Konstantinos Dimitriou. "The Greek Crisis: Tragedy or Opportunity?" Harvard Business School BGIE Unit Case 711-088 (2011).

[23] Aristides N. Hatzis. "Greece as a Precautionary Tale of the Welfare State,"p. 22.

[24] Ioannis N. Grigoriadis. "Greek tragedy." *World Policy Journal* 28.2 (2011), p.103.

[25] Rebecca M. Nelson, Paul Belkin, and Derek E. Mix. "Greece's debt crisis: Overview, policy responses, and implications," p.2.

[26] Nasos Mihalakas. The Real Cause of the Greek Sovereign Debt Crisis. *Diplomatic Courier* (A Global Affairs Magazine), May 01, 2012. http://www.diplomaticourier.com/news/regions/eurozone/273-the-real-cause-of-the-greek-sovereign-debt-crisis. Accessed on July 6, 2012.

The roots of Greece's current situation can be traced back to its 1974 constitution and the developments after becoming a member of the EC/EU. Sklias and Maris (2013) point at several "institutional phenomena indicators" during the last 30 years, "whose negative performance is the root cause for today's Greek complex situation." These are: statism, governance performance, populism, failed Europeanization, corruption, political stability, and parliamentary continuity. As a result, "the Greeks followed a misleading model of political, economic, and institutional development that directly or indirectly affected their political and economic choices and preferences and their way of thinking." Greece has been a real laggard in economic and institutional developments among the EU countries.[27]

Greece has a parliamentary system of government, where executive and legislative branches merge, and the Prime Minister (PM) is the most powerful actor as the head of the executive branch. The current constitution of Greece, which concentrates most power into the hands of the PM, came to existence after the collapse of the military junta in the summer of 1974. In Greece, the PM not only has strong executive powers, but also controls legislative processes through his cabinet and parliamentary teams--as the leader of usually the majority party in the parliament. After the constitutional reforms of 2001, parliamentary committees, which are composed of different parties according to their size in the parliament, started to play a role. "But, even with the enhanced role of the Parliamentary committees during the past decade, most money-spending legislations (pensions, local or special taxes, or charges of any nature on behalf of agencies, and government bills resulting in an expenditure or a reduction of revenues) have to come with the consent/signature of the Minister of Finance – who of course serves at the pleasure of the Prime Minister."[28] In Greece, judicial review of constitutionality of laws is also weak. The President with mostly ceremonial powers appoints or dismisses ministers with the recommendation of the PM, who has the real power in determining his cabinet members. Without a counter-weight to its power, Greece's central government, headed by the PM, has been quite strong.

Historical origins of a strong central administrative structure go back to the formative years of the Greek state. Old traditions of localism and community action, coming from the Ottoman period, were replaced by a centrally controlled bureaucratic state apparatus. According to Kamaras (2014), "long-established, autonomous local elites were displaced in the 1920s, their place taken by a new group of people adept at managing a rent-seeking relationship with the state."[29] In Michas' (2011) words:

> "Since the 1930s, political patronage has been disbursed through increases in public sector employment, regulations that limit competition, and the imposition of levies on transactions that benefit third parties. The resulting system has encouraged corruption, discouraged wealth creation and affected popular ideological narratives. The view that the state is good and that markets are bad is widespread, held across the political spectrum, and is understandable in a rent-

[27] Pantelis Sklias and Georgios Maris. "The political dimension of the Greek financial crisis," p.153.
[28] Nasos Mihalakas. The Real Cause of the Greek Sovereign Debt Crisis. *Diplomatic Courier* (A Global Affairs Magazine), May 01, 2012. http://www.diplomaticourier.com/news/regions/eurozone/273-the-real-cause-of-the-greek-sovereign-debt-crisis. Accessed on July 6, 2012.
[29] Antonis Kamaras. The Origins of the Greek Financial Crisis: Letter from Thessaloniki. *Foreign Affairs.* December 13, 2011. http://www.foreignaffairs.com/features/letters-from/the-origins-of-the-greek-financial-crisis. Accessed July 4 2014

seeking society where all activities, including market transactions, are seen as redistribution. But the realization of "putting people above markets" has deepened clientelism and produced the current national crisis …. Greece has a system in which political support is provided in exchange for material benefits known as "rousfeti" in Greek. The state is the instrument for creating and distributing rents or benefits among various client groups. In this situation, rent-seeking—the attempts by groups and individuals to influence the political allocation of benefits—becomes paramount."[30]

During the period after 1974, state expansionism, accompanied by nationalization of select industries, became an instrument of the new democratic regime, and was adopted by the country's major parties. The 1980s has been a defining decade of Greece, starting with the election victory of the Panhellenic Socialist Movement (PASOK) in 1981, after Greece joined the EC/EU. Among its election rhetoric, politics to benefit the "non-privileged" attracted voters from self-employed craftsmen, tradesmen, agricultural laborers and low- and middle-ranking state officials. As PASOK followed expansionist policies and increased government spending, the Greek economy experienced high inflation and low growth during their rule in the early 1980s. Ailing industries were bailed out by the state for electoral purposes. Greece started to lose its international competitiveness during this decade. The Greek government avoided electorally painful economic reforms that are required by the EC/ EU in line with its Single Market Act.[31] The Greek state's heavy involvement in the economy also negatively affected Greece's compliance with the EU's stabilization and convergence programs. The state continued to expand with laws, such as "the socialization of public enterprises and the nationalization of many public organizations" (1368/83) in the 1980s and 1990s. The Greek state controlled about 75% of all business assets and tightly regulated other sectors of the economy in 1990. The state's control was reduced to about 50% by 2008 with privatization efforts. However, the state did not lose its "sovereignty" over the business even in the 2000s. Complex regulations accompanied by incoherent and unsystematic approaches to business law continued to bring additional costs and burdens to businesses. Expansion of the state required more finances in order to cover increased public involvement in the economy, and reduced private initiatives for growth and effectiveness of free market actions. The people's perception of the state's role also changed and cronyism increased.[32]

Starting from the 1980s until the 2012 parliamentary elections during the crisis, two political parties – PASOK and the more pro-business New Democracy (ND) party— controlled the government and dominated Greek politics and Greece's electoral laws,[33] creating a polarized two party system. PASOK's economic policies served well politically, but created a bloated welfare

[30] Takis Michas. "Putting politics above markets: historical background to the Greek debt crisis." Cato Working Paper Cato Institute (2011), pp.2-3.
[31] Dimitris Tsarouhas. "The political origins of the Greek crisis: domestic failures and the EU factor," p.88.
[32] See Rebecca M. Nelson, Paul Belkin, and Derek E. Mix. "Greece's debt crisis: Overview, policy responses, and implications," p.2; Pantelis Sklias and Georgios Maris. "The political dimension of the Greek financial crisis," p.153.
[33] According to Mihalakas "Greece uses a complex reinforced proportional representation electoral system which discourages splinter parties and makes a parliamentary majority possible even if the leading party falls short of a majority of the popular vote." For more information see Nasos Mihalakas. The Real Cause of the Greek Sovereign Debt Crisis….

state with increased government spending and reduced incentives for investment with overregulation of the private sector. The party called for a socialist transformation of the Greek economy and used very ideological political rhetoric in its early years. During the period of 1981-1985, "the socialization process together with the development of statism created a skewed and continuously increasing nexus of governmental activities that developed the rent seeking actions and behaviors of the public managers."[34] The ND's early ideological platform was abstract and oriented toward authoritarianism, since the party integrated a branch of the pro-junta Greek far right. After1984, the ND leaned toward the neoliberal ideological platform and became Greece's conservative party, supported by mostly middle and upper class voters, and increased its share in the rural and agrarian population. Until the early 1990s, the two parties engaged in a fierce political confrontation as ND attempted to confront PASOK's socialist platform and adopted neoliberal ideology. ND called "for extensive privatizations in the economy and the cutback of the public sector." However, this confrontational stance started to decline in the 1990s. PASOK's rhetoric attracted a large share of the vote among working and middle low classes that proved crucial for its electoral wins in the 1981, 1985 and 1993 elections. PASOK's political success over time pushed the conservative New Democracy Party to imitate PASOK's populist policies for political gains; at the beginning in more limited ways.[35]

Both parties had agreement on the country's entrance to the European Monetary Union (EMU). Over time, both parties, broadly speaking, agreed on the goals of economic policies and policy instruments to achieve those goals. Ideological differences between the two parties decreased, both became pro-EU, pro-free trade and open markets, pro-public health/education, pro-higher pensions yet low taxes and so on.[36] Instead, both political parties acted according their political interests and competed for populist policies, which was disastrous for the economy. As a result, economic growth rates lowered, and public deficits and public debt increased.

Populism, which contributed to the mismanagement of public finances and the economy, has become one important characteristic of the Greek political system. As Hatzis (2012) puts it: "spending is popular for politicians because it buys votes in the short-term…. It's popular with the voters because they tend to see government benefits as a windfall. They don't see the money as coming from their own pockets, but from "the government," or at least from someone else's pockets." [37] Populist policies may have started with the left-leaning Papandreou era, but the ND party also continued with populist policies. According to Grigoriadis (2011), "Greek governance truly hit its nadir during the 2004 to 2009 administration of Kostas Karamanlis, leader of the center-right New Democracy (ND) party." Low interest rates provided by the Eurozone

[34] Pantelis Sklias and Georgios Maris. "The political dimension of the Greek financial crisis," p.156.
[35] Aristides N. Hatzis. "Greece as a Precautionary Tale of the Welfare State." *After the Welfare State edited by Tom G. Palmer, Atlas Economic Research Foundation, Washington, DC* (2012). P.23. Also see, Pavlos Vasilopoulos and Christoforos Vernardakis. "The Rise and Fall of the Greek Conservative Party: Ideological Realignments and Egocentric Economic Voting at the Dawn of the Financial Crisis'." 61st Political Studies Association Annual Conference. 2001. P.2
[36] Pavlos Vasilopoulos and Christoforos Vernardakis. "The Rise and Fall of the Greek Conservative Party: Ideological Realignments and Egocentric Economic Voting at the Dawn of the Financial Crisis'." 61st Political Studies Association Annual Conference. 2001. P.2. Also see Nasos Mihalakas. The Real Cause of the Greek Sovereign Debt Crisis….
[37] Aristides N. Hatzis. "Greece as a Precautionary Tale of the Welfare State," p. 25.

membership of Greece enabled the Karamanlis government to increase government spending and borrowing sharply.[38]

Availability of cheap and plentiful credit, after the adoption of the Euro in 2002, enabled Greek politicians to finance deficit spending along with current account deficits. Being part of the Euro, they did not worry about inflation or a devaluation of the currency. Much of the borrowed money went to finance consumption instead of investment, infrastructure and institutional development.[39] In the 2000s, as government expenditures were increasing, tax revenues were not increasing at the same rate. Tax evasion has been a chronic problem. Greece's complex tax code grants exemptions to numerous professions and income brackets. Clientelism could also have been an important factor behind pervasive tax evasion. Before the crisis, the Greek state taxed only one third of officially declared incomes, at an average tax rate of 30%. However, Greece had a huge unrecorded economy-- about 30% of official GDP according to some estimates—that was not taxed. Most analysts see political clientelism "as emblematic of a broader distrust of state institutions" and as the root cause of widespread tax evasion. Low tax revenues were offset by access to cheap credit by Greek governments. In the 2000s, government budget and trade deficits ballooned. Instead of addressing these structural deficits, Greek governments continued to borrow money, much of which went to fund current consumption and not much of which went to productive investments that would generate future growth and/or increase the competitiveness of the economy, providing streams of revenue with which to repay the debt.[40]

Along with widespread tax evasion, corruption was also a chronic problem in Greece. According to Transparency International's 2010 Corruption Perception Index, Greece was ranked the most corrupt in the EU, after Bulgaria and Romania.[41] The lack of a stable and developed civil society, the overgrown state, political centralization and the clientele networks all contributed to corruption. In addition, Greece's complex legal framework provides room for maneuvering around corrupt situations, and its political culture provides space for such "pathogenic behavior."[42]

Each of the major parties tried to return favors to its respective clientele after (re)gaining power. They designed and implemented policies according to electoral and narrow party interests, rather than adopting policies that would best serve the country. Greek politicians saw "the provision of public sector jobs and benefits as an important way to grant favors and thereby secure electoral support."[43] Thus, they filled public institutions, such as public universities, hospitals, public utility organizations, and administrative services with their supporters and caused a massive growth of the public sector. "The end result was an oversized and overcrowded public sector subservient to the political parties whose size kept increasing"[44] In the 2000s, an important

[38] Ioannis N. Grigoriadis. "Greek tragedy." *World Policy Journal* 28.2 (2011), p.104.
[39] Aristides N. Hatzis. "Greece as a Precautionary Tale of the Welfare State," pp.25-26
[40] Rebecca M. Nelson, Paul Belkin, and Derek E. Mix. "Greece's debt crisis: Overview, policy responses, and implications," pp.2-3.
[41] Rebecca M. Nelson, Paul Belkin, and Derek E. Mix. "Greece's debt crisis: Overview, policy responses, and implications,"p.2.
[42] Pantelis Sklias and Georgios Maris. "The political dimension of the Greek financial crisis," p.158.
[43] Rebecca M. Nelson, Paul Belkin, and Derek E. Mix. "Greece's debt crisis: Overview, policy responses, and implications," p.2.
[44] Yannis Theocharis and Jan W. Van Deth. "Causes and Consequences of the Greek Crisis," pp.7-9.

portion of increasing government spending went to public sector wages and benefits. "As recently as 2009, Greek government expenditures accounted for 50% of GDP, with75% of (non-interest) public spending going to public sector wages and social benefits. According to the OECD, while spending on public administration as a percentage of total public expenditure has been the highest in the OECD, there has been "no evidence that the quantity or quality of the services are superior." [45]

Both parties "reinvented and reorganized the patronage networks through the use and abuse of their mass party organizations which were exploited in order to penetrate the state machine as well as the organized interests and parts of civil society."[46] Thus, political parties penetrated to all areas of public life, including organized interests, universities, civil service, and local and regional authorities. The terms "partitocrazia" and "bureaucratic clientelism" are used to describe the functioning of the Greek political system. The manner in which political parties behaved created patronage networks, inefficient public sectors and a weak independent civil society. They prioritized their own interests and used their relations with the state for that purpose. The image of the country started to be associated with graft, bribery, and corruption prior to the crisis. "It is the dominance of this image that led to today's endless allegations and recriminations between the political parties about the involvement and guilt of their members in economic scandals."[47] Greece's clientelist system, with socialist elements in it, significantly contributed to the extension of the welfare state and inefficient industrial policies. [48]

Moreover, each governing party refrained from any politically risky policy or reform; instead they kicked "the can down the road" to next government. Each party used their government powers and control of the public purse to stay in power as long as they could; not for reforms and fixing the public finance imbalances. "They focused only on how they can shower their respective constituents with benefits, while attracting independents to their promises for reform."[49] The lack of party political consensus for reform and strong opposition of powerful interest groups also contributed to the failures of reform attempts.

This is not to say that there have not been any attempts for reform, but they mostly failed. For example, during the 1981-1985 period, the PASOK economic policies, as discussed before, created an expanded bureaucracy, state control of the economy, and poor economic performance. As the public deficit and debt were rising, the second PASOK government, which was elected in 1985, experimented with a program of fiscal consolidation. But, just two years later the program was reversed when it became unpopular. When party leaders noticed that their re-election was at stake, they continued with increased public sector expenditures, with mostly borrowed money. The EC/EU guaranteed financial support being on their side, and continued with their deficit-financed social policy. In the late 1980s, amidst corruption allegations, Greece experienced political instability due to short-lived coalition governments. The EC warned Greek governments about the country's deteriorating economic situation—20.4 % inflation, a 15.9 percent public

[45] Rebecca M. Nelson, Paul Belkin, and Derek E. Mix. "Greece's debt crisis: Overview, policy responses, and implications," p.2.
[46] Christos Lyrintzis. "Greek politics in the era of economic crisis: reassessing causes and effects.," p. 3.
[47] Christos Lyrintzis. "Greek politics in the era of economic crisis: reassessing causes and effects," pp. 5-7.
[48] Chris Rogers and Sofia Vasilopoulou. "Making Sense of Greek Austerity." The Political Quarterly 83.4 (2012), p. 778.
[49] Nasos Mihalakas. The Real Cause of the Greek Sovereign Debt Crisis….

deficit, quadrupled interest payments compared to the 1981 level, and so on-- and policy measures that needed to be adopted to prevent an economic catastrophe. However, no policy measures were adopted and implemented. Also, the government failed to invest in education and R&D; labor productivity was in decline. Growth rates were maintained with a construction boom artificially and later with the 2004 Olympic Games.[50]

Another example is the failed pension or social security system reforms. Starting from the 1990s, it was obvious that a reform of the system was needed. The Greek pension system with a low retirement age and inequalities in coverage and benefits had various problems. In 1990, the ND government came to power with a promise to reform the system that "was responsible for half the cost of public deficit and absorbed 15 percent of the country's GDP." The pressure from the EU and obligation to meet the Maastricht criteria of 1992, which will be discussed in the next section, also empowered the government and gave an excuse to pursue the reforms. However, the ND also failed to address the structural deficiencies of the pension system with a radical reform. It mainly brought a few changes in the retirement age. When PASOK was re-elected with a narrow margin in 2000, the party's manifesto involved reform of the social security system, as well. Despite the warnings of the Bank of Greece that the pension system was a "ticking bomb" threatening to derail the country's finances,[51] the reform attempt failed as described in the following paragraph.

The PASOK government initiated a legislation proposal in order to reform the burdensome social security system in 2001. The proposal also included employment and income tax reforms. Named after the then Labor Minister, the "Gannitsis 2001 law" had to be withdrawn due to strong opposition from various organized interest groups including public sector trade unions, professional associations, and political parties. PASOK itself was divided as the pros and cons of the proposal. Instead, the government proceeded with a "light" reform in order to keep interest groups happy, and in fact, raised some pensions despite the strain it brought on public expenditures.[52] Pressured by the EU directives, Greece adopted some reforms as related to employment policies, vocational training, and regional development. But, more fundamental social security reforms remained mostly on paper. Various private interest groups, bureaucratic mechanisms, populist and influential media, and party traditionalists strongly resisted any radical reform of the welfare system.[53]

In Greece, like in "other peripheral countries," the existence of well organized labor / trade unions prevents labor-related reforms, keeps real wages high, and thus the country's international competitiveness low. The strong labor/ trade unions, caring only about protecting benefits of their own members, rejected even sensible policy solutions and declined the government invitations in the late 1990s and early 2000s to cooperate in finding solutions to labor market problems. Relations between them and the political class had been a patron-client relationship. Greek interest groups and government could not find a negotiated solution to problems, and could not "Europeanize social dialogue" with a balance between the competing interests of labor

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[50] Dimitris Tsarouhas. "The political origins of the Greek crisis: domestic failures and the EU factor," pp. 87-88.
[51] Dimitris Tsarouhas. "The political origins of the Greek crisis: domestic failures and the EU factor," p.90-91.
[52] Chris Rogers and Sofia Vasilopoulou. "Making Sense of Greek Austerity," p. 778.
[53] Dimitris Tsarouhtsis. "The political origins of the Greek crisis: domestic failures and the EU factor," pp.90-91.

and capital.[54] According to Sklias and Maris (2013), "in Greece many powerful interest groups can be identified that influence political and economic stability and development negatively. …these numerous rent-seeking groups curtail competition in the product and services markets, increase red tape and administrative burdens, and actively seek to establish opacity in all administrative and legal processes in order to form an environment in which they will be able to increase the rents they extract. ...Entrenched sectional interests sought to defend their accumulated privileges, whilst an inefficient and financially unsustainable system failed to meet the legitimate needs of other social groups."[55]

From a Public Choice perspective, voters are rational and vote according to their individual interests. According to Pappas and Aslanidis (2012), excluding swing votes, "Greeks used to vote more or less along clientelistic and rent-seeking lines" until the breakdown of the two-party-system in May 2012 elections, when two major parties, especially PASOK, lost their support. As discussed, the two parties had a firm control over the state apparatus, and were eager to "dole out favors upon assuming power in order to solidify support." During the crisis, as the PASOK government was forced to commit itself to the austerity measures, state resources to clientelistic networks were no longer available. Therefore, voters associated with interest groups that used to reap the fruits of the old system, such as trade unions, professional associations, and state-fed media tycoons, were affected negatively and withdrew their support in the May 2012 election from the major parties, supporting instead the political parties that promised to protect the status quo and prevent the reforms.[56] Therefore, the traditionally dominant parties, which both supported the harsh austerity measures, could not earn enough votes in the elections to form a majority government. New Democracy (ND) earned 18.9% of the votes, PASOK, which had over 40% of the votes in the previous election, gained only 13.2% of votes in this election. Thus, left-wing populists with the rhetoric of the welfare state and wealth inequality, and right wing populists with their rhetoric along the line of national and religious themes increased their votes and power in the parliament.[57] The election results showed Greek society's collective dissatisfaction. Greece's fragmented party system could not create a coalition government and the elections were repeated in June 2012. The two traditionally major parties formed a coalition government after the elections, since no single party gained a majority in the Parliament.

Despite the electoral laws designed to increase political stability, Greece's parliamentary system has been unstable. The main reason is that ruling political parties often decide to have an early election as longs as it serves the party's interests and increases its political power. Also, government ministers are reshuffled multiple times during the same term, as related to patronage and clientelism in Greece. Since 1974, Greece should now have its 11th government, if every government completed its term, but the 17th government is currently serving. This is nearly 1.5 times as many governments. The average government term in Greece is 2.86 years, excluding

[54] Chris Rogers and Sofia Vasilopoulou. "Making Sense of Greek Austerity," p. 778; Dimitris Tsarouhas. "The political origins of the Greek crisis: domestic failures and the EU factor,"p.89; and Pantelis Sklias and Georgios Maris. "The political dimension of the Greek financial crisis," p. 150.
[55] Pantelis Sklias and Georgios Maris. "The political dimension of the Greek financial crisis," p.155.
[56] Takis S Pappas and Paris Aslanidis. "Evolving Greek Politics Amidst the Crisis: Destination Unknown." (2012).
[57] SeeTakis S Pappas and Paris Aslanidis. "Evolving Greek Politics Amidst the Crisis: Destination unknown." (2012).

coalition governments and taking into account only completed terms.[58] Given that Greece had only 3 coalition governments, the overwhelming majority of the governments had been single party controlled governments. Despite this, not only did the governments change too often, but also the election laws have changed 6 times in Greece since the establishment of democracy in 1974.[59]

Greece could have avoided the crisis since the country had no "housing bubble" or an exposure to American "toxic assets." Its banking system was also functioning fine. As discussed earlier, the crisis hit Greece mainly because of the mismanagement of the public finances—government deficits and debt accumulation. Timely reforms also could have prevented the Greek debt crisis. However, due to lack of incentives in reducing government budget deficits and self-interested behavior of parties, subsequent governments postponed reforms. Through structural reforms and appropriate policy measures, Greek governments could have reduced budget deficits, controlled government debt, reversed the decline of national savings, and increased the economy' competitiveness, thus reducing the current account deficit. Voters and special interest groups who benefited from the status quo blocked reform efforts. A strong and independent civil society outside the party apparatus, representing "common goods" did not exist.

As will be discussed in the next section, EU leaders and EMU authorities did not have a strong will or the mechanism to push Greece to timely reforms as well. Membership to the EC/ EU was supposed to bring political and economic modernization or "Europeanization" to Greece. Greece entered the EC in 1981, as a result of Prime Minister Konstantinos Karamanlis' 'Westernisation' agenda, signaling the victory of reformists.[60] However, Greece had been "a laggard regarding the typical and real adoption of the European rules and the European institutional context" and fell behind some of the member countries which joined the EC/ EU after Greece. The EU took legal action for Greece's noncompliance with the European directives in multiple cases since the early 1990s.[61]

Global and Regional Contexts: How did they contribute to Deteriorated Economic Variables?

The Impact of Weak Rule Enforcement in the EU Context

The Maastricht Treaty of 1992 set convergence criteria for EU member countries that wanted to join the EMU. Also, the member countries were bound by additional rules in the Stability and Growth Pact of 1997. According to the convergence criteria , after completing three discrete development stages between 1990 and 1999, the EU member countries interested in joining the EMU were supposed to achieve the following: (1) price stability with an average inflation of no more than 1.5%; (2) low interest rates, which can only be up to 2% above the three best member states; (3) annual budget deficits less than 3 percent of GDP and a debt-to GDP ratio of no more

[58] Pantelis Sklias and Georgios Maris. "The political dimension of the Greek financial crisis," p.159-160. Also see Nikitas-Spiros Koutsoukis and Spyros Roukanas. "The Greek crisis that should have been avoided," pp.22-23.
[59] Nikitas-Spiros Koutsoukis and Spyros Roukanas. "The Greek crisis that should have been avoided," p.24.
[60] Chris Rogers and Sofia Vasilopoulou. "Making Sense of Greek Austerity," p. 779.
[61] Pantelis Sklias and Georgios Maris. "The political dimension of the Greek financial crisis," pp.156-157.

than 60 percent; (4) currency stability with fluctuations of less than 2.5% around the central rate.[62]

The Stability and Growth Pact came as a Franco-German compromise and anchored the common monetary policy to Germany. Its purpose was to ensure budgetary discipline and to prevent member countries' governments from running large deficits after the start of the EMU in 1999. It brought some procedures for multilateral budgetary surveillance, a coordination of national fiscal agendas on a European level, and determined the conditions of applying for "the excessive deficit procedure." Together with the economic convergence criteria, it "was supposed to create the fiscal and economic coordination optimally needed for a currency union."[63]

In order to achieve the targets of the EMU's convergence criteria, many countries had to cut public spending and raise taxes. However, the enforcement of the standards was not consistent. Both the assessment for the eligibility for entry into the Euro, and the application of rules were weak. Different countries had different preferences. Leaders of some EU countries with weaker economies, like Italy, Spain, and eventually Greece, preferred to defer tougher fiscal measures, since the political price of cutting public spending and raising taxes was high. According to Alessi (2013), "the powerful original members of the EEC, such as Germany, were eager to develop a large and competitive Eurozone, and so allowed less solvent EU nations to adopt the Euro even if they had failed to fulfill the criteria outlined by Maastricht." [64] Greece, along with other weaker economies, was allowed to join the EMU without meeting the convergence criteria. For example, Greece's debt-to-GDP ratio in 2000 was 103%, far above the 60% criteria.[65] It remained above 100 percent throughout the 2000s. Also Greece's deficit-to-GDP ratio remained higher than the EMU's maximum 3 percent. [66] Political calculations played an important role in the start of the EMU, and economic and fiscal principles came second.

The deficit countries survived with access to cheap credit, which was available after joining the Euro. For example, even when Greece was preparing to adopt the Euro, interest rates on 10-year Greek bonds dropped from 24.5% to 6.5% between 1993 and 1999. Prior to the crisis, investors were in expectation of widespread convergence among countries in the Eurozone, reinforced by the convergence criteria.[67] However, these criteria were not followed strictly.

Moreover, Greek statistical authorities circumvented standard accounting practices and used statistical techniques that ignored best practices and international standards in order to hide the sharp rise of the government debt. For this purpose special deals were made with Wall Street firms like Goldman Sachs. During the crisis, it was understood that the statistical figures released by Athens were not reliable. Not only is there a global lack of rules to prevent governments' misleading accounting practices, but also the EU's regulations and supervision have been weak.

[62] Shelby Woods. "The Greek Sovereign Debt Crisis: Politics and Economics in the Eurozone," p.7; and see Rebecca M. Nelson, Paul Belkin, and Derek E. Mix. "Greece's debt crisis: Overview, policy responses, and implications,"p.3.
[63] Shelby Woods. "The Greek Sovereign Debt Crisis: Politics and Economics in the Eurozone," University of Washington, pp.7-8.
[64] Christopher Alessi. The Eurozone in Crisis….
[65] Federal Reserve Bank of St. Luis. The Sovereign Debt Crisis: A Modern Greek Tragedy…
[66] Federal Reserve Bank of St. Luis. The Sovereign Debt Crisis: A Modern Greek Tragedy…
[67] Rebecca M. Nelson, Paul Belkin, and Derek E. Mix. "Greece's debt crisis: Overview, policy responses, and implications," p.3.

The Eurostat's effort to increase reliability by sending its delegations to Athens multiple times from 2004 onward could not prevent the misreported statistics before the crisis. As we mentioned before, the Papandreou government (PASOK)'s revelation that the real budget deficit-to-GDP ratio was well above what the previous ND government claimed shocked the markets in 2009. The government used "securitizations operations" in order to achieve given accounting results as explained next.

Greece, Italy, and some other European countries, with the assistance of Goldman Sachs and JP Morgan Chase, and similar investment banks, were able to hide their mounting debt and/or deficits liabilities through some off-balance sheet transactions as well as the use of complex currency and credit derivatives developed by these banks. Of course, these banks were paid millions of dollars for their "services" that enabled politicians to mask their additional borrowings. Here are some examples: Massive amounts of Greek debts and loans were converted into Yen and Dollars at a fictitious exchange rate and were treated as a currency trade rather than a loan, in order to hide the true extent of Greek loans. In exchange for future payments by governments, banks provided cash up-front, and the liabilities of involved countries were "kept off the books." In other words, governments sold their future revenues, and "Greece, for example, traded away the rights to airport fees and lottery proceeds in years to come."[68] Essentially, Greek officials mortgaged the country's airports, high ways, and such by swapping cash up front with future proceeds from these places. These transactions were classified as sales, not as loans.

Such deals mislead investors and regulators about the debt of involved countries' liabilities. These countries and involved investment banks were not transparent about such derivatives, which were not openly documented or disclosed. Wall Street firms, seeking to maximize their profits, enabled Greece and others to borrow beyond their means. Of course, politicians, who want to pass the ball forward, took the opportunity of these derivatives offered, passing fiscal and economic imbalances to the future. Instead of raising taxes and reducing government spending, these governments artificially reduced their deficits with derivatives.[69]

Credits given to some European countries were disguised as "swaps" and did not get registered as debt. Such financial derivatives at the time were ignored by the Eurostat as well. Thus, Maastrict rules were circumvented via "swaps." The purpose was to hide the actual deficits from the EU. The revised statistics revealed that Greece exceeded the European stability criteria since joining the Eurozone. Thus, Greece was able to circumvent EU rules for a decade. Of course the original sin was that Greece and some other countries entered the EMU without meeting the criteria.

Not only did Greece's domestic institutional budget framework allow self-interested politicians to adopt fiscal policies that served them, but also the Eurozone institutions, designed according

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68 Louise Story, Landon Thomas Jr. and Nelson D. Schwartz, Wall St. Helped to Mask Debt Fueling Europe's Crisis. The New York Times, Global Business February 13, 2010.
http://www.nytimes.com/2010/02/14/business/global/14debt.html?pagewanted=all&_r=2&. Accessed July 6, 2014. Also see http://en.wikipedia.org/wiki/Greek_government-debt_crisis, Accessed July 5, 2014

69 Louise Story, Landon Thomas Jr. and Nelson D. Schwartz, Wall St. Helped to Mask Debt Fueling Europe's Crisis. …

to wishes of the major EU members, were not affective in enforcing the rules. Thus, the institutional structure of the EMU, and the European political environment also contributed to preparing the conditions for the Greek debt crisis. The ECB had only limited power and banking regulations had been national. The EMU was established without fiscal and banking unions, which are discussed next.

If the Maastricht criteria were enforced more strictly, Greece could have avoided accumulation of government debt to unsustainable levels. Closer following of the EU directives, principles and standards could have helped Greece to reform its rigid labor markets and overcome low international competitiveness. Currently, all EU member states are required to join the Eurozone when they meet the criteria, with the exception of the UK, Denmark, and Sweden. The Eurogroup, which comprises the seventeen Eurozone finance ministers, controls the process.

Lack of Fiscal and Banking Unions

When European leaders decided for monetary union in 1992, as Moravcsik (2014) puts it, they "took a risk by assuming that European economies would converge toward one another: the deficit-prone countries of southern Europe would adopt German economic standards -- lower price inflation and wage growth, more saving, and less spending -- and Germany would become a little more like them, by accepting more government and private spending and higher wage and price inflation."[70]

The Eurozone members had vastly different fiscal and economic policies, and they could not achieve the convergence that is described above. Even though a fiscal union or stricter cooperation would bring discipline on national governments' incentives to borrow and spend, the EU countries were not ready for their budgets and taxes to be controlled by Brussels. Fiscal union would require member countries to give up their sovereign authority to tax, spend, and borrow to finance government deficits. The crisis showed the EU leaders that they needed closer fiscal integration.

Being in the Eurozone and having the common currency and unified capital markets benefited Greece, as a member of the EMU. Although Greece needed Germany and France's help during the crisis, these countries had little say over Greece's budget policies prior to the crisis. Neither could they stop the Greek government from borrowing, nor were they able to "enforce their banks' claims on Greek borrowers or seize Greek assets."[71] The lack of political and institutional convergence in the Eurozone prevented full economic and fiscal convergence. In such an institutional environment, Greece and maybe some other member countries were not able to implement the economic policies to achieve EU-determined policy targets "via fiscal adaptation, liberalization of capital movements, convergence of inflation and interest rates and stabilization of exchange rates as they are described in the Maastricht Treaty."[72] Also the EU lacked

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[70] Andrew Moravcsik, Europe After the Crisis: How to Sustain a Common Currency. Foreign Affairs, May/June 2012 Issuehttp://www.foreignaffairs.com/articles/137421/andrew-moravcsik/europe-after-the-crisis. Accessed on July 4 2014.
[71] Dani Rodrik. "Greek lessons for the world economy." *Project Syndicate* 11 (2010). Accessed via http://www.relooney.info/0_New_7354.pdf. on July 11 2014.
[72] Pantelis Sklias and Georgios Maris. "The political dimension of the Greek financial crisis," p. 149.

contingency rules in regards to what would happen if a member nation, such as Greece, leaves or is kicked out of the EMU. The EMU mechanism and decision making process was slow during the crisis as well. The EU leaders handled the crisis with last-minute rescue packages, and were not able to create a mechanism to reassure the markets that the Eurozone had a credible solution in a more timely fashion. The crisis escalated and contagion problems emerged as markets did not perceive a clear policy direction in the Eurozone.[73] More firm and decisive actions were taken two years into the crisis.

In fact, EU members were caught in the crisis before they could achieve full convergence of their economic policies. The crisis showed that economic integration requires greater political cooperation and conditions of economic policies and that European institutions must still evolve in that direction to have a healthy single market. [74] Eventually, the EU leaders increased their efforts to create more centralized governance mechanisms and to coordinate fiscal and economic policies. Among these, EU leaders, excluding the UK and Czech Republic, agreed to the formation of a fiscal union in December 2011. This German-engineered fiscal compact will allow "the EU to dictate the national budgetary policies of participating nations."[75] They also announced plans of creating a single banking authority, a step toward a banking union. Some analysts believe that major banking reforms are delayed due to the strong banking lobby in the EU. Still, EU-wide control over risky practices by banks and financial institutions is missing.

All in all, the Eurozone members have dealt with the short-term symptoms of the crisis, but they need to make progress toward overcoming the long-term challenges in regards to making European economies converge. The Eurozone with a single currency and monetary policy has to assure that domestic macroeconomic behaviors of member countries are similar to one another, aligning their public spending, competitiveness, and inflation trends.

The Impact of the Global Context

In today's financial affairs, the world cannot ignore financial crises happening in a particular country or region due to their multiple economic, financial, and political implications at domestic, regional, and international levels, nor can those countries or regions dealing with their own crises ignore their network of linkages with the outside world. The recent global crisis that started in the US was easily transmitted to Europe and hit Greece. Not only the crisis itself, but also global financial developments prior to the crisis had an impact on Greek borrowing and accumulation of debt.

Globalization of financial markets enabled easy credit conditions and encouraged high-risk lending and borrowing. International trade imbalances caused accumulation of huge capital in surplus countries that financed deficit countries' current account deficits. In the 2000s, international transfer of savings has increased accompanied by a wave of financial innovations. In the meantime, as international trade grew, current account imbalances have been funded by

[73] Dimitris Tsarouhas. "The political origins of the Greek crisis: domestic failures and the EU factor," p.92.
[74] Dani Rodrik. "Greek lessons for the world economy.".
[75] Christopher Alessi. The Eurozone in Crisis. …

global finance. Savings of trade surplus countries and those of oil producing countries were invested financial assets in Western countries, including 'risk-free' loans to households of the US and Europe.[76] Risks were hidden via complex financial instruments, such as collateralized debt obligations, CDOs and credit default swaps, CDSs. Because of the exposition of European banks to such assets, the crisis was transmitted from the US to Europe. After the collapse of Lehman Brothers, financial institutions holding the "toxic assets" were no longer solvent. Such global financial developments were not accompanied by global cooperation among governments and international financial institutions to set rules and put constraints on risky behaviors.[77]

Global financial markets treated the long term bonds of the countries of the Eurozone similar to that of Germany until the crisis. During the crisis, they altered the risk perceptions of government debt, and started to assess the risks of Eurozone countries' government bonds based on each country's macroeconomic performance. The bonds of South Eurozone countries, including Greece, Portugal, Spain, and Italy, became very volatile since the markets perceived higher risks than that of North Eurozone countries. As discussed earlier, Greek government bonds were seen as the most risky by the markets and therefore had the highest yields.

Self-interests of Involved Parties also affected how the Crisis was Handled

Resolving the Greek sovereign debt crisis involved a complex network of actors, including the leaders and governments of major EU counties, the EU institutions including the ECB, the IMF, private financial institutions, the Greek government and Greek public including various interest groups. All these had an interest in achieving a resolution to the crisis, but each tried to minimize the cost of resolution for themselves.

Greece's crisis-time governments had to accept the austerity measures despite the objections of the Greek public and loss of popularity of the political parties that ran these governments. The external actors forced Greek governments to accept the austerity measures. Among them were global private capital and financial institutions. In the era of global finance and capital mobility, the governments that cannot give confidence to the global financial markets are punished by these financial actors via their "exit" weapon. [78] Sudden outflow of volatile finance could destabilize financial markets of a country, put its banks in trouble, and push its economy in a recession leading to low investment, low tax revenue, and high unemployment. This feature of global and European financial markets also forced Greek governments to accept austerity measures, since they do not have a better option for instilling confidence in the markets again, financing the government deficits, keeping their banks running, and getting the economy on a healthy path.

Greek governments were squeezed between the pressures of financial markets and external/ EU actors on the one hand, and Greek public and interest groups, whose interests were affected negatively by austerity measures, on the other hand. Governing parties had to get the approval of

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[76] Anton Brender, and Florence Pisani. "Global imbalances and the collapse of globalised finance." (2010).

[77] Anton Brender, and Florence Pisani. "Global imbalances and the collapse of globalised finance." (2010); and also see P. N. (Raja) Junankar. Book Review: The Global Minotaur: America, the True Origins of the Financial Crisis and the Future of the World Economy …

[78] Chris Rogers and Sofia Vasilopoulou. "Making Sense of Greek Austerity," p. 777.

the general population, and if they cannot their prospects of re-election diminish, which happened to Greece's major parties in the May/ June 2012 elections. Worse, governments face indirect challenges to the state's political authority, in the form of violent protests, as happened in Greece.

The Greek governments also had to accept the demands of the troika members: the EU, the IMF, and the ECB, in order to be able to get the bailout packages and roll over the country's debt. If Greece could not get the bailout packages, it would default. A Greek default would cause a bigger crisis in the Eurozone with severe global repercussions. In fact, the troika members also had clear interests in a successful resolution of the Greek crisis. A Greek default would set a dangerous precedent that would make investors very nervous about lending to other highly-indebted nations, such as Italy or Spain, with a weak economy. If investors stop buying the bonds of indebted countries, governments of those countries would not be able to roll over their debt to pay to their creditors. In turn, if indebted countries cannot pay their debt, a credit crunch could occur, leading the Eurozone economies into a deeper recession and weakening banking systems in the Eurozone countries. Addressing the Greek debt crisis was important for the EU and the ECB for the maintenance of the broader European project. Having the IMF on their side was also useful, since it brought more credibility to conditions associated with the loans. The highly criticized IMF had a chance to re-establish its reputation[79] and demonstrate effectiveness of its structural adjustment programs.

The Troika's phased response was also important for preventing a crisis in the European banking sector. Given the huge exposure of banks of the Eurozone countries to Greek debt, a Greek default could lead to bank runs, especially in vulnerable economies, such as Greece, Portugal and Spain. Total exposure of Eurozone countries' banks to Greece was $272.4 billion out of a total of $298.3billion in Greek liabilities at the end of September 2009, according to data from the Bank for International Settlements.[80] As the figure below shows, French banks were most exposed to the Greek debt, then British, and German banks. Some of these banks are major global banks, and a Greek default would not only put the whole European banking system in trouble, but its effects would echo around the globe.[81]

Therefore, the Eurozone leaders, in particular French and German leaders, had a clear interest in solving the Greek crisis as smoothly as possible and avoiding a Greek default, despite the fact that it was hard to persuade the German public for the bailout. They ensured that these loans were conditioned on austerity measures to prevent repetition of the same situation and a moral hazard. According to Oatley (2012), "the Greek debt crisis brought into the open for the first time a distributive conflict that had always been implicit in the EU's monetary union. This distributive conflict focused on one central question: who would bear the cost of Greek's excessive debt burden?" [82] A Greek default would bring the cost onto the institutions and individuals that held Greek debt. The austerity measures pushed the cost on the Greek government and people. If bailout loans were given to Greece without the austerity measures,

[79] Chris Rogers and Sofia Vasilopoulou. "Making Sense of Greek Austerity," p. 792-783.
[80] Chris Rogers and Sofia Vasilopoulou. "Making Sense of Greek Austerity," p. 792-783.
[81] Louise Story, Landon Thomas Jr. and Nelson D. Schwartz, Wall St. Helped to Mask Debt Fueling Europe's Crisis...
[82] See Thomas H. Oatley. International political economy, pp. 245-246.

such action would cause taxpayers in Germany, France, and other northern European countries to pay the bill. If the ECB depreciated the Euro, a weaker euro would benefit Greece, but it would generate inflation to northern Europe.[83] Therefore, the EU governments tried to shape the responses to the crisis according to their interests and pushed for the policy option that brought the least cost them.

The bailout deals occurred because they were preferred by all parties to a unilateral and disorderly Greek default. It is possible to argue that the bailout package (s) came out as result of a negotiated solution to these distributive conflicts. Ardagna and Caselli (2012) characterize the 2010 bailout deal as a "political-economy equilibrium in the sense that, for each of its signatories, it was individually rational to agree to it." They reached similar conclusions about the 2011 bailout, and argued that both deals were Pareto suboptimal, but the sub-optimality was more obvious in the second one.[84] The bailout deals were forced on Greece by not releasing disburses whenever Greece failed to fulfill its obligations.

Conclusions

Financial crises are significant economic, political and international events. They have been the repetitive feature of the global economy today. This paper, informed by Public Choice economics, traced the roots of the Greek sovereign debt crisis within the country's external and domestic institutional and political contexts. Within these contexts, it attempted to demonstrate self-interested behaviors of Greek politicians, government officials, and interest groups that affected the economic policies negatively, which in turn led to deterioration of economic and fiscal variables that made Greece vulnerable to the crisis.

As discussed before, Greece had some structural and chronic problems: persistent government budget deficits due to the country's bloated government bureaucracy, very generous pension and health-care benefits and government employee salaries, an uncompetitive economy, extensive state involvement and regulation in the economy, inflexible labor markets, corruption, and widespread tax evasions, especially by the wealthy. In Greece's political and institutional contexts, Greek politicians acted according to their political interests and ignored the economy's long-term health. They granted rents to multiple rent-seeking interest groups in Greece rather than acting for the long term economic efficiency, competitiveness, and overall well-being of the economy. As a result, Greek governments, prior to the crisis, not only kept running large government deficits, and therefore, accumulated huge sovereign debt, but also did not or could not adopt economic reforms and wise economic policies that could have prevented at least the severity of the crisis. The Greek governments ignored chronic structural fiscal problems, corruption, and widespread tax evasion, even though the increased government spending necessitated increased tax revenues. In 1992, members of the EU signed the Maastricht Treaty, under which they pledged to limit their deficit spending and debt levels, but several members, including Greece, have failed to stay within the confines of the Maastricht criteria. The structure of the Eurozone monetary union has been created without banking and fiscal union among the Eurozone countries. Without a fiscal union, the EU institutions did not have much control over

[83] See Thomas H. Oatley. International political economy, p. 245-246.
[84] Silvia Ardagna and Francesco Caselli. The Political Economy of the Greek Debt Crisis: A Tale of Two Bailouts, pp.2-3.

member countries' budgets and spending, and due to lack of banking union and insufficient regulations, European banks exposed themselves to risky loans.

Due to the bank exposures to Greek debt in the EU countries, especially those of France, the UK, and Germany, and the possible contagion effect on the other high debt-to-GDP countries, the EU leaders could not allow Greece to default. A Greek default could have endangered the functioning of the EU's financial institutions by possibly causing bankruptcies and credit freezes; worried market participants and banks would not lend new money to other potentially vulnerable countries in the EU. The whole EU would have experienced a much more severe recession. After long negotiations, EU leaders decided on the first bailout package of €110 billion with the IMF's support--then the largest amount a country has ever taken in the EU-- in May 2010. However, it was insufficient and, therefore, the second bailout package of €130 billion came in February 2011. The bailout packages came as result of a negotiated solution to distributive conflicts among involved parties. The EU's bailout funding countries--Germany being the major one--and the IMF, requested austerity measures from the then Greek government, which included tax rises and cuts in benefits and wages. Such austerity measures caused dramatic social developments among which were big street protests and police violence, extreme poverty and inequality, and political and xenophobic violence in Greece.[85]

As argued throughout this paper, there are deeper political, institutional, and societal causes of the Greek sovereign debt crisis. These factors led to the deterioration of Greece's economic/ financial and fiscal variables that made the country susceptible to a crisis. We cannot evaluate economic variables in isolation from political and institutional factors. The crisis was brought by the interaction of political and institutional factors with economic and fiscal variables.

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[85] See for the social implication of the crisis, Dimitris Dalakoglou. *The crisis before 'the crisis': violence and urban neoliberalization in Athens.* Social Justice, 39 (1), 2012. pp. 24-42.

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