Governance, Growth and the Recent Economic Crisis: The Case of Greece and Cyprus
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Abstract

Greece and Cyprus are two countries that have been affected gravely by the international economic crisis. As a result both countries were cut off from the international financial markets, and resorted to rescue packages financed by the IMF, the European Commission and the ECB (known as troika). Because of the austerity programs both countries have entered a period of deep recession. In this paper we argue that the length of the adjustment period does not depend only on the severity of the adjustment measures, but also on the quality of institutions and governance mechanisms of the two countries. On the basis of well accepted indicators for the quality of institutions and public governance, we argue that the shorter period of recession in Cyprus is due not only to the less severe policies imposed by troika, but also to the higher quality of its institutions and governance mechanisms.

Keywords: Governance, institutions, economic crisis, Greece, Cyprus.

1. Introduction

One issue that has been debated widely, over the last two decades, is the role of institutions and good governance on economic development and growth. Several empirical studies have established the conclusion that long-term growth and quality of institutions are closely related, although the causation and the way these variables interact are still highly debated. Good governance is certainly the reflection of sound institutions, and according to Acemoglu (2008) governance can be defined in various different ways. “In the context of economic growth and development, governance refers to essential parts of the broad cluster of institutions”. Accordingly, governance includes the functioning of political institutions, the checks and balances of the political system of a society, the capacity of the state to provide public goods and services and to implement effectively and efficiently policies and reforms, and to regulate economic activity. As noted by Dixit (2009), good governance is needed to secure three essential
prerequisites of market economies, (1) Security of property rights, (2) Enforcement of contracts, and (3) Collective action. Moreover, as Rodrik (2008) stresses:

“If you want to achieve lasting change and have a real impact on the behavior of those agents that determine the success of reform, you must change the “rules of the game” – the manner in which ... policy is made or fiscal policy is conducted...These reforms target a lengthy list of objectives, including reducing corruption, improving the rule of law, increasing the accountability and effectiveness of public institutions, and enhancing access and voice of the citizenry. The agenda is neatly captured and quantified by the Kaufmann-Kraay Governance Indicators data set”.

The creation of quantitative measurements of good governance has been central to the work of many researchers, in their effort to establish the links between governance and growth. Among the many indicators of good governance, the most well-known are, the Corruption Perceptions Index produced by Transparency International and the Worldwide Governance Indicators produced by Kaufmann and his associates at the World Bank. These indicators have a wide range of users, from academics to international investors, and international organizations. It is true, however, that in the last few years there is a proliferation of other institutional and governance indicators, like those published by the World Economic Forum, the French Development Agency (AFD), etc.

Although the effects of governance on growth have been widely explored, an issue that recently gains interest is the extent to which weak institutions and governance prolong crises.¹ In a recent paper Bluhm, et. als. (2013) find evidence that weak institutions precede crises and also that strong institutions shorten the duration of crises. This issue is quite relevant for the countries of the Eurowea that are in deep recession because of the recent international financial crisis. A pertinent question is to what extent the economic recession is due not only to the crisis but also to the quality of institutions of these countries, and if the quality of institutions affects the exit from the crisis.

¹ For an interesting review of the literature on institutions and growth, see Bluhm and Szirmai (2012). An excellent review of the subject is that of Acemoglu and Robinson (2010). For a more specific review of the effects of governance on growth for the EU countries see Dima, et. al. (2013).
Two countries that have been gravely affected by the crisis are Greece and Cyprus. The causes of the crisis are certainly different, but both countries are under rescue packages jointly funded by the IMF, the EC and the ECB (known as troika). For both countries the troika recipe is fiscal retrenchment and structural reforms. It is well established, however, that the implementation of policies are greatly affected by the quality of institutions and governance. As Frankel (2011) has noted “It is not enough to recommend good fiscal policy to a country – or for the IMF to make loans to a country conditional on good fiscal policy – if … institutions are not there to sustain the policy”.

The purpose of this paper is to examine the basic features of the crisis in Greece and Cyprus, the quality of governance in the two countries and the prospects for exiting the crisis. In the second section of the paper we will explore briefly the causes of the crisis on the basis of some indicators for macroeconomic imbalances before the crisis. In the third section, we will examine the quality of governance of the two countries, mainly on the basis of the Worldwide Governance Indicators published by the World Bank, but also based on indicators published by the World Economic Forum. In the fourth section, we will attempt to evaluate the programs that are currently implemented in both countries and the prospects for exit from the crisis. Finally, in the fifth section we will attempt to draw some conclusions.

2. Macroeconomic imbalances before the crisis

In the period before the world financial and economic crisis, Greece and Cyprus had a satisfactory economic performance, with gdp growth rates above the European Union (EU) and the Euroarea average (see figure 1). This was the period of convergence with the EU average, and both countries had more or less the same level of per capita income. However, during the same period, several macroeconomic imbalances developed (see Table 1). Greece proved unable to contain general government deficits and consequently to reduce public debt. It is also notable that after joining the Euroarea there was a gradual deterioration of the country’s international competitiveness, as expressed by the current account deficits. In Cyprus, the problem was not in the public sector, but mainly in the private sector with the explosion of the private debt and the enormous expansion of the banking sector. Also the international competitiveness deteriorated, although not as much as in Greece. If we take the overall debt (General Government and Private Sector Debt together), we observe that Greece is less indebted than Cyprus, and it is below the EU average.
What is particularly worth mentioning is the explosion of the activity of the banking sector in Cyprus, with the assets of the sector reaching the level of 689% of GDP, almost twice as high as the EU average, in 2008, the year of the financial crisis. In Greece, in 2008, the level of private sector debt was much lower than the EU average and the bank assets as percent of GDP was, at about 200%.

**TABLE 2**

*Bank assets as % of GDP*

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<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
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<th>2011</th>
<th>2012</th>
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<tr>
<td>Greece</td>
<td>148.2</td>
<td>154.1</td>
<td>175.4</td>
<td>199.3</td>
<td>213.2</td>
<td>231.8</td>
<td>228.7</td>
<td>228.2</td>
</tr>
<tr>
<td>Cyprus</td>
<td>460.0</td>
<td>522.3</td>
<td>584.2</td>
<td>688.6</td>
<td>827.0</td>
<td>775.4</td>
<td>745.4</td>
<td>716.3</td>
</tr>
<tr>
<td>Total-EU27</td>
<td>306.9</td>
<td>324.5</td>
<td>338.9</td>
<td>346.9</td>
<td>364.6</td>
<td>361.1</td>
<td>365.8</td>
<td>351.8</td>
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### TABLE 1

*Indicators of macroeconomic imbalances*

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<tr>
<td><strong>Greece</strong></td>
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<tr>
<td>Current Account balance as % of GDP (^1)</td>
<td>-6.6</td>
<td>-8.3</td>
<td>-11.2</td>
<td>-13.6</td>
<td>-13.6</td>
<td>-12.1</td>
<td>-10.4</td>
<td>-7.5</td>
</tr>
<tr>
<td>Private Sector Debt as % GDP, consolidated</td>
<td>73.4</td>
<td>97.1</td>
<td>106.3</td>
<td>118.1</td>
<td>122.2</td>
<td>127.6</td>
<td>129.2</td>
<td>129.1</td>
</tr>
<tr>
<td>General government deficit/surplus</td>
<td>-5.5</td>
<td>-5.7</td>
<td>-6.5</td>
<td>-9.8</td>
<td>-15.7</td>
<td>-10.7</td>
<td>-9.5</td>
<td>-9.0</td>
</tr>
<tr>
<td>General Government Debt as % of GDP</td>
<td>100.6</td>
<td>107.5</td>
<td>107.2</td>
<td>112.9</td>
<td>129.7</td>
<td>148.3</td>
<td>170.3</td>
<td>156.9</td>
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<tr>
<td><strong>Cyprus</strong></td>
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<tr>
<td>Current Account balance as % of GDP (^1)</td>
<td>-3.8</td>
<td>-6.0</td>
<td>-8.2</td>
<td>-11.5</td>
<td>-12.7</td>
<td>-12.1</td>
<td>-8.0</td>
<td>-6.7</td>
</tr>
<tr>
<td>Private Sector Debt as % GDP, consolidated</td>
<td>174.4</td>
<td>199.8</td>
<td>220.4</td>
<td>238.2</td>
<td>257.7</td>
<td>274.0</td>
<td>286.6</td>
<td>299.2</td>
</tr>
<tr>
<td>General government deficit/surplus</td>
<td>-3.9</td>
<td>-1.2</td>
<td>3.5</td>
<td>0.9</td>
<td>-6.1</td>
<td>-5.3</td>
<td>-6.3</td>
<td>-6.4</td>
</tr>
<tr>
<td>General Government Debt as % of GDP</td>
<td>67.3</td>
<td>64.7</td>
<td>58.8</td>
<td>48.9</td>
<td>58.5</td>
<td>61.3</td>
<td>71.5</td>
<td>86.6</td>
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*Notes:* \(^1\) 3 year average; All indicators as a percent of GDP and the private sector debt is on a consolidated basis.
The fiscal imbalances in Greece were not sustainable, and with the financial markets in turmoil, the Greek economy was cut off from the markets. The need to finance its huge deficits led the government to ask for the assistance from the European Union and the International Monetary Fund. Under the Memorandum of Economic and Financial Policies (MEFP) that was initiated by the European Commission, the European Central Bank and the International Monetary Fund (troika), Greece had to make a huge fiscal consolidation and to adopt radical structural reforms in all sectors of economic activity.

In Cyprus, the problem was not the fiscal imbalances but the private sector debt, and the size of the banking sector. With large exposures in Greece, the main Cypriot banks were heavily affected by the recession in the Greek economy, and the crisis in Cyprus was triggered by Greek debt restructuring, together with realized and prospective loan losses in both Cyprus and Greece. As a result of these developments Cyprus was cut off from the markets and had to ask for the assistance of troika.

What has happened in both countries are now well known, and are described in detail in the reports of the IMF and the European Commission. Greece and Cyprus are in deep recession, with huge losses in GDP and unemployment at levels without precedent in periods of peace. As the data of Table 3 reveal Greece entered a protracted period of recession in 2008 and a small positive growth rate is forecasted for 2014. Cyprus managed rather well in the first years after the international financial crisis, but after the domestic banking crisis it also entered a period of deep recession in 2012, and the forecast is that there will be a slight recovery in 2015.

One question that arises is what the causes of these crises are. Are they the result of bad economic policies or are they related to other factors, such as the institutional framework of the two countries and their governance mechanisms? There is no doubt that for Greece the lax fiscal policies after the country joined the Euroarea, and the poor monitoring of fiscal developments, not only by the Greek authorities, but also by the fiscal surveillance mechanisms of the European Commission and the IMF, have led to large general government deficits and a huge public debt.²

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² For a review of the poor fiscal governance in Greece, see Kaplanoglou and Rapanos (2013).
TABLE 3

Forecasts of basic macroeconomic indicators

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<tr>
<td><strong>Greece</strong></td>
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<tr>
<td>GDP growth rate</td>
<td>-0.2</td>
<td>-3.1</td>
<td>-4.9</td>
<td>-7.1</td>
<td>-6.4</td>
<td>-3.7</td>
<td>0.6</td>
<td>2.9</td>
</tr>
<tr>
<td>Unemployment¹</td>
<td>7.7</td>
<td>9.5</td>
<td>12.6</td>
<td>17.7</td>
<td>24.3</td>
<td>27.3</td>
<td>26.0</td>
<td>24.0</td>
</tr>
<tr>
<td>General government deficit²</td>
<td>-9.8</td>
<td>-15.7</td>
<td>-10.7</td>
<td>-9.5</td>
<td>-9.0</td>
<td>-13.1</td>
<td>-2.2</td>
<td>-1.0</td>
</tr>
<tr>
<td>General government debt²</td>
<td>112.9</td>
<td>129.7</td>
<td>148.3</td>
<td>170.3</td>
<td>156.9</td>
<td>177.3</td>
<td>177.0</td>
<td>171.9</td>
</tr>
<tr>
<td><strong>Cyprus</strong></td>
<td></td>
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</tr>
<tr>
<td>GDP growth rate</td>
<td>3.6</td>
<td>-1.9</td>
<td>1.3</td>
<td>0.4</td>
<td>-2.4</td>
<td>-6.0</td>
<td>-4.8</td>
<td>0.9</td>
</tr>
<tr>
<td>Unemployment²</td>
<td>3.7</td>
<td>5.4</td>
<td>6.3</td>
<td>7.9</td>
<td>11.9</td>
<td>16.0</td>
<td>19.2</td>
<td>18.4</td>
</tr>
<tr>
<td>General government deficit²</td>
<td>0.9</td>
<td>-6.1</td>
<td>-5.3</td>
<td>-6.3</td>
<td>-6.3</td>
<td>-5.5</td>
<td>-5.8</td>
<td>-6.1</td>
</tr>
<tr>
<td>General government debt²</td>
<td>48.9</td>
<td>58.5</td>
<td>61.3</td>
<td>71.1</td>
<td>85.8</td>
<td>112.0</td>
<td>121.5</td>
<td>125.8</td>
</tr>
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</table>

Notes: ¹ As percent of labour force; ² As percent of GDP.

What is also interesting to note is that the programs initiated by troika for both countries ask, in addition to the macroeconomic measures, for radical reforms in goods and labour markets and the public sector, with the aim of restoring competitiveness, and thus enhancing growth prospects. The basic proposal of the structural reforms program is based on the principles of the Washington Consensus, namely that any kind of liberalisation and reduction of the size of the public sector is welcomed. The success of the programs does not depend, however, only on the soundness of macroeconomic and structural policies, but also on the capacity of the state mechanisms of the two countries to successfully implement these policies. This has been partially recognised by troika, and it is reflected by the setting up, by the European Commission, of the Task Force for Greece, under the leadership of Mr. Reichenbach, aiming at helping Greece to reform its public sector. There is no such program for Cyprus, an indication that the governance mechanisms in Cyprus are more efficient than those in Greece. It is this issue that we will attempt to deal with in the following section.
3. Institutions and governance mechanisms

From the preceding analysis it becomes evident that the slump in economic activity in Greece and Cyprus has nullified the positive growth effects of the last decade, and it will take many years for the recoup of the lost output. Why the decline in Greece is much deeper and much longer than in Cyprus? One explanation is that this may be due to weaker institutions in Greece that bring with them increased vulnerabilities to crises. Acemoglu et al. (2003) argue that:

“...the major causes of the large cross-country differences in volatility are institutional, and none of the standard macroeconomic variables appear to be the primary mediating channels through which institutional causes lead to economic instability. These macroeconomic problems, just like the volatility and the disappointing macroeconomic performance suffered by these countries, are symptoms of deeper institutional causes.” (p. 108).

Regarding the measurement of institutions and the quality of governance, several indicators have been proposed. These indicators can be divided according to several criteria. Some measure formal institutions, some measure informal institutions and some other a combination of formal and informal institutions. The issue has been hotly debated, and we will not enter into a discussion of it. Also, given that Greece and Cyprus are developed countries, with well-functioning democratic systems, we limit our study on the basis of well-known institutional and governance indicators, like those published by the World Economic Forum and the World Bank.

3.1. Quality of institutions and competitiveness

Let us examine the quality of institutions, as measured by the World Economic Forum (WEF), for the period 2007-2008 to 2010-2013, i.e. from the start of the crisis until 2013. At the starting of the crisis the index of quality in Cyprus was the same as the average of the European Union (EU), and slightly lower for Greece. Since then, however, we observe a small deterioration for the EU average, an initial improvement for Cyprus and deterioration after 2010, but a significant decrease for Greece. This indicates that the crisis has affected negatively the quality of institutions, and this became quite acute with the economic recession in Greece. This may sound paradoxical, since the troika, in addition to the measures for fiscal adjustment, imposed also measures for structural reforms that aimed

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3 For a review of the relevant literature see Woodruff (2006), Kaufmann et.al. (2011), and Langbein L. and S. Knack (2010).
at improving the functioning of government, and the improvement of competitiveness. In the IMF “Staff Report on Request for Stand-By Arrangement”, in May 2010, (IMF 2010a) it is emphatically stressed that:

“Greece needs a strong program of structural reforms to restore competitiveness and growth… reforms will focus on streamlining public administration and making it more transparent, improving the business climate and seeking better contested markets throughout the economy”.

FIGURE 2
Quality of institutions (Scale 1-7 best)

Similar recommendations are made for Cyprus by the IMF, with the aim of preserving and improving competitiveness⁴. It is interesting, however, to explore in more details the quality of institutions by decomposing it into two sub-indexes that refer to public and private institutions. According to the WEF the index for public institutions measures elements that relate to Property rights, Ethics and corruption, Undue influence, Government efficiency, and Security, while the index for private institutions measures Corporate ethics and Accountability. As depicted in Figures 3a and 3b, the quality of both public and private institutions has deteriorated in the period of crisis, and particularly so in Greece. It is notable that in Greece the index for private institutions has deteriorated even more than the index for public institutions and it started recovering in 2013. While the deterioration for Cyprus and the EU is more or less the same, the question is why this deterioration, and why such a big difference between Greece

⁴ See IMF (2010b) pp. 18-21.
and Cyprus. One explanation may be that the recession in Greece started much earlier than in Cyprus, but also that the institutions in Greece were at quite fragile. The deep recession, the cuts in wages, the uncoordinated reduction of government employment through both voluntary and mandatory schemes, and the not carefully planned reshuffling of government agencies had as a result the weakening of the public sector governance mechanisms. Probably the worsening of public governance affected negatively the compliance of the private sector to accountability rules and ethical behaviour.

FIGURE 3a
Quality of private institutions

FIGURE 3b
Quality of public institutions
The quality of institutions is closely related to the competitiveness of a country as defined by the indicators of WEF and depicted in Figure 4 for the EU countries. The relationship between competitiveness and institution is confirmed by a recent study of Huemer et. al. (2013). The authors propose a new competitiveness index (based largely on the indexes of the WEF) that captures the dimensions in which politics can influence competitiveness beyond factor price adjustments, in other words it measures the effects that governance can have on competitiveness.

**FIGURE 4**

*Global Competitiveness and institutions*

Besides competitiveness, a major problem for Greece and Cyprus is the very large fiscal adjustment that has to take place in a rather short period of time, and the improvement in the efficiency of the fiscal institutional mechanisms of the two countries in order to manage more efficiently the revenue and expenditure sides of the budget. In order to examine these dimensions, we will make use of some indicators from the Worldwide Governance Indicators (WGI), published by the World Bank annually. From this dataset we will select four indicators, namely Government Effectiveness, Political Stability, Rule of Law and Control of Corruption, which reveal the capability of the government and the political system to effectively deal with the pressing fiscal consolidation.
3.2. Governance and fiscal adjustment

Before proceeding to the examination of the above mentioned indicators, it might be worth mentioning what really these indicators mean. According to the initiators of these indicators Kaufmann, et. al. (2011)\textsuperscript{5}:

**Political stability and absence of violence/terrorism (PV)** – captures perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.

**Government effectiveness (GE)** – captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies.

**Rule of law (RL)** – captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

**Control of corruption (CC)** – captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as ‘capture’ of the state by elites and private interests.

In the following analysis we will make use of the WG indexes in percentile rank terms ranging from 0 (lowest) to 100 (highest) among all countries worldwide. Let us start by presenting first the index for political stability.

**Political stability**

As we observe in Figure 5, the level of political stability in Greece and Cyprus is below the EU average for the whole period under examination. For the period of the crisis, however, we note a significant deterioration in Greece, while in Cyprus we observe a stable trend of convergence with the EU average. This can be explained by the fact that in 2007 there was an early election in Greece in which the incumbent party of New Democracy won the election but with marginal majority. This government stayed in office until the autumn of 2009, and in the election that took place at the end of that year, the main opposition party (PASOK) won the election. However, the tough measures that the government took to face the unprecedented fiscal crisis, destabilized the government, and in November

\textsuperscript{5} For a recent critical review on the meaning and use of governance indicators, see Gisselquist (2013)
2012, a new bipartisan government took office that ran the country until May 2012. After two consecutive elections, a new coalition government took office in June 2012. It is true that the political stability was negatively influenced by the fiscal crisis, but it reflects also the vulnerability of the political system to major shocks.

It is well established in the literature that political instability negatively affects growth, and thus the process of fiscal adjustment. As Aisen and Vega (2011) stress

“...governments in politically fragmented countries with high degrees of political instability need to address its root causes and try to mitigate its effects on the design and implementation of economic policies. Only then, countries could have durable economic policies that may engender higher economic growth.”

In Cyprus, the presidential system seems to assure higher political stability, as it is nearly impossible to remove a president from power. It is, of course, possible that the president may not have the support of the majority of the Parliament and this makes the implementation of reforms difficult. Yet, the present crisis has shown that the Cypriot Parliament has exhibited a high degree of maturity, and it passed, almost unanimously, all the fiscal measures included in the memorandum before the agreement.

For a recent review of this subject see Aisen Jose Veiga (2011).
with troika was signed. The political climate has deteriorated since, but remains much more civil than in Greece.

Another point that reflects the difference in the general political and social climate between Greece and Cyprus is the reaction of the public to the measures voted by the Parliaments. While Greece was flooded with strikes, in Cyprus the protests were limited, even when banks were closed for two weeks. It is also indicative of the general public’s understanding that even when banks reopened there was no rush to the banks.

**Rule of Law**

The impact of the rule of law on economic growth has become one of the more dynamic areas of theoretical and empirical work in political science, economics, and law. The rule of law affects growth through a range of channels, such as the protection of individual property rights, guaranteeing fair and credible contract enforcement, setting and enforcing labour laws, facilitating market creation and access, etc.⁷ For Cyprus the rule of law index has improved over the last few years, and from 2005 on it is above the EU average. In Greece, there is a period of convergence towards the EU average until 2004, in which period the country became member of the Eurozone, but after 2004 we observe a divergence and a clear deterioration during the period of crisis. For Cyprus there is a continuous improvement and after 2005 the performance is better than the EU average.

The obvious question that arises is how it happened and the rule of law deteriorated so rapidly in Greece. The answer may be due to the deep economic and social crisis. Since the indexes used are perception indexes, the general impression in the country is that the functioning of all institutions and governance mechanisms has been affected negatively. This may, however, reflect also a reality, since public expenditures were cut drastically across all sectors of the economy, including the judiciary and the police. The above trend is also confirmed by similar indicators published by the World Economic Forum (2014).

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⁷ For a comprehensive review of the literature on rule of law and growth, see Haggard and Tiede (2011).
A well-functioning public sector is essential for the smooth functioning of an economy, the wellbeing of people, and the advancement of the activity of the private sector. Efficient and effective governments offer better and at low cost services to citizens and to businesses. This is particularly important in the context of recovering from the on-going economic crisis, since companies and particularly small and medium enterprises can benefit from reduction of time and costs, faster responses and better support of public administration.

The data of Figure 7 reveal that Cyprus, for the whole period, had an index of government effectiveness higher than the EU average, and this improved after 2003. For Greece, however, the index, although close to the EU average in 1996, has steadily deteriorated after 2004, and the deterioration accelerated during the period of crisis. One could expect an amelioration of government effectiveness in the recent years, since the improvement of the public administration was and still is one of the priorities of the troika program.
As stated in the fourth review by the IMF (2013a)

“Civil service reforms are critical to improve the efficiency and quality of public services, lower the total amount of public sector employment (through attrition) and the public sector wage bill, and bring in young and skilled workers for those whose positions have become obsolete (through exit and the mobility scheme). But, as noted earlier, progress in completing staffing plans and placing public sector employees in the mobility scheme has been very slow.” (p. 14).

In reality, however, the reform of the public administration has been very slow, and at the same time the number of general government employees declined by more than 200,000 after 2009, while there were also important cuts in the compensation of public sector employees and in public expenditure in general. The data are presented in Table 4. The expenditures are presented as percentage of GDP, but these data distort the real cuts since in the period after 2009 there was also a huge drop in GDP. That is why the data in nominal terms give a more accurate picture of the expenditure adjustment in Greece. Hence, while both, the general government expenditures and the compensation of employees as a percent of GDP remains more or less stable, in nominal terms the cuts are quite significant. This is itself an indication that slashing the size of the government sector does not per se improve its effectiveness. What has rather been the case in Greece is that the huge expenditure cuts and the reduction in the employment in the public sector in combination with the

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8 The increase of general government expenditures as percent of GDP in 2013 is due mainly to the one off expenditures for the recapitalization of Greek banks.
slow reform explain probably the deterioration in government effectiveness.

In Cyprus, the program for fiscal adjustment came much later than in Greece, and its effects started becoming visible only in 2013 and 2014. Moreover, the reforms in public administration proposed by troika are mainly of structural nature and do not imply important reductions in the employment in the public sector and large cuts in the wages of civil servants.⁹

### TABLE 4

*Changes in public expenditures and compensation of government employees: ESA 199*

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⁹ For a detailed presentation of the proposed by troika reforms in Cyprus, see IMF (2013b).
More specifically, for Cyprus, the IMF proposes reforms to “…enhance tax revenues by improving tax compliance and collection; and undertake reforms of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services” (IMF 2013b. p.81).

This probably indicates that the public sector effectiveness is rather satisfactory, and as the indicators reveal it has been consistently higher in Cyprus than in Greece and the EU average. An explanation that is usually given is that Cyprus, being in the past a British colony, has inherited a system of public administration and governance structures that are much more efficient than in Greece. The Greek legal system and the public administration system have been influenced by the Continental system of bureaucracy that is less flexible and less adjustable to changing economic conditions. This in combination with a clientelistic political system created an inefficient and costly public administration.

**Control of corruption**

One of the most debated issues in Greece is the high level of corruption, in comparison with other countries with similar level of income. The literature on corruption and economic performance is quite voluminous. In a recent comprehensive review of the issue, Ugur and Dasgupta (2011) conclude by stating that:

“… the evidence synthesised in this review indicates that corruption has negative and statistically significant effects on growth – directly and indirectly, and in both LICs and non-LICs. … However, the findings also indicate that the economic gains from targeting corruption in low-income countries are likely to remain small if interventions aimed at reducing corruption are not combined with a wider set of interventions aimed at improving the quality of governance institutions in general”.

In another interesting recent work, Aidt (2009) also concludes that:

“While corruption in a very narrow sense can be seen as a lubricator that may speed things up and help entrepreneurs get on with wealth creation in specific instances, in a broader sense, corruption must be considered as an obstacle to development. This is so for a number of related reasons”.
FIGURE 8
Control of corruption

The Control of Corruption index, from the WGI, is depicted in Figure 8, where we observe once again, that Cyprus has a quite good performance, with the index being higher than the EU average, and it is rather stable over the whole period (1996-2012). In Greece, the index started falling, somewhat paradoxically, after the country joined the Euroarea, and the deterioration accelerated after 2004, and particularly after the outbreak of the crisis. Taking into account the measures that the government has undertaken, it is true under the pressure of troika, to combat tax evasion and fraud, one would expect an improvement in the perception for corruption. Instead, we see a clear deterioration. One partial explanation may be that because of the deep recession with a result the large cuts in the wages of civil servants and the police, and the reduction in the employment in these sectors, the auditors and policemen are quite disheartened to fight corruption, and/or more prone to bribery. The increase in corruption, however, during the crisis is not only a Greek phenomenon. It has been observed in other advanced countries that experienced deep recessions. It is interesting to mention, at this point, the recent evidence provided by the OECD (2014), according to which:

“Countries which suffered the biggest declines in GDP from 2007 to 2012 were also among those where corruption had increased (Figure 7.9). Increase in corruption was particularly high in countries such as Estonia, Greece, Ireland and Portugal. These countries also saw a stronger decline in confidence in the national
Does this indicate that Cyprus will also experience an increase in corruption during the years of crisis? This is something to be seen. It is worth noting, however, that in the latest report of Transparency International, 79% of Cypriots believe that corruption will increase due to the present financial crisis. If, as the OECD says, this is related to the decline of confidence in government and other institutions, like parliament, judiciary, etc., then what will happen in Cyprus may depend on the trust of the people to basic institutions, as we will examine later. It is worth examining at this point the relationship between quality of institutions as defined by the WEF and control of corruption from the WGI data. As revealed by the data of Figure 9, the relationship is really quite strong, although the causation is a more difficult issue, since the causality underlying this relationship is likely to run both ways. A major reason why this is so is the fact that corruption indicators tend to be highly correlated with other public sector governance indicators, like the rule of law, government effectiveness, etc.

The critical question for countries that are in the process of huge fiscal adjustment, like Greece and Cyprus and which have to reduce very high levels of public debt, is how the reduction of corruption can affect this process. A possible channel through which corruption affects fiscal adjustment is by influencing both the volume and the composition of government expenditures and revenues. On the one hand, high corruption affects revenues by reducing both direct and indirect tax revenues, and therefore reduces the ability of the government to provide adequate levels of public services to facilitate private sector development. On the other hand, corruption affects also the expenditure side of the budget through the diversion of resources from productive activities (e.g. health, education and productive infrastructures) to less capacity enhancing activities. Moreover, corruption may accentuate inequalities, and this makes the fiscal adjustment more painful for the vulnerable segments of the society.
3.3. Trust in Institutions

The role of trust on economic performance has attracted the interest of economists and social scientists for some decades now. A classic reference to the role of trust in market economies is that of Arrow (1972):

"Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence."

The literature on the role of trust is quite rich, but the purpose of this paper is to examine the issue of trust in some basic institutions that play a role in the fiscal adjustment process.\textsuperscript{10} That is why, we will limit our research in presenting some data on how trust in institutions like, government and

\textsuperscript{10} For a very comprehensive review of the literature on the role of trust in economic activity, see Algan and Cahuc (2013).
national parliaments, has evolved over the last few years, and how it has been affected by the crisis. Let us see first, how trust in government has evolved over the last 10 years, on the basis of data from the Eurobarometer.

**FIGURE 10**

% of people who tend to trust national government

It is interesting that from 2004 until 2008 the percentage of people that trusted government was higher in Cyprus and Greece than in the EU on average. Since then, however, the decline is very rapid in Cyprus and Greece, while in the EU it is much smaller. The situation is very worrying in Greece, since with only 9% of people trusting the government, it is very difficult to convince people for the need of tough measures that are essential for fiscal consolidation and the stabilization of the economy.

The situation is even worse when we come to the trust to national parliaments (Figure 11). It is true that the level of trust before the crisis, in both countries was rather high in comparison with the EU average. After the crisis, however, the decline is very dramatic, particularly in Greece, where, in 2013, only 10% of people trust the parliament. In Cyprus the level of trust is around 20%, while the decline in trust in the other European countries, after the international economic crisis, was much smaller. With so low levels of trust in the most basic political institutions, the economic policy making and implementation becomes quite problematic. Trust does not only reduce transaction costs, something that affects economic efficiency, but it also makes economic policy makers more
credible, which enhances the prospects for an effective implementation of needed policies. The low trust in the political system implies high degrees of political instability, which certainly hampers growth and may prolong the recession period.

![Figure 11](image)

% of people who tend to trust national parliament

The deterioration of political stability in Greece is confirmed by the index we analysed earlier on the basis of the WGI relevant index (see figure 5). In Cyprus the index for political stability remains stable, which can be explained by the fact that the country has a presidential system of governance that is not affected so much by changes in the strength of political parties in the Parliament.

3.4. Institutions and economic policies

In the preceding analysis, we have attempted to present evidence on the evolution of some governance indicators and their relationship with the economic performance in Greece and Cyprus. It is true that, despite their difference in the quality of institutions and governance mechanisms, both countries achieved high growth rates from the early 1990s until the outbreak of the crisis and had a similar per capita GDP level. How is this possible?
In the case of Greece, part of the explanation might be that in this period of time, the country implemented a set of sound macroeconomic policies that reduced significantly general government deficits, and reduced other macro imbalances that helped the country to satisfy the preconditions for joining the Euroarea. As a result, Greece entered a period of low interest rates, and with a favourable international environment, the country experienced a high GDP growth period. At the same time, however, the weak fiscal governance resulting from low quality fiscal institutions did not facilitate a sustainable improvement in the fiscal position of the country. General government debt remained at high levels, yet the favourable conditions in international financial markets allowed for its refinancing. The situation was abruptly overturned with the outbreak of the crisis. Mounting general government deficits could no longer be financed, the country was cut off from financial markets and the government resorted to the rescue programme by the troika. So, bad fiscal policies after the mid-2000, and weak fiscal governance, in an environment of international crisis led the country to an unprecedented recession.

From the data is clear that Cyprus has had already a much better institutional framework, which seems not to have been affected significantly by the crisis. From the early 1990s, Cyprus also experienced high growth rates, with no major fiscal imbalances. The main imbalance that developed was the high level of the private sector debt, which in the advent of the international crisis led the country to a crisis in the banking sector, and subsequently to a fiscal crisis. How can one explain that the sound public governance mechanisms have not prevented the country from having such a huge banking crisis that subsequently led to the present deep recession? One partial explanation may be that the general governance indicators we employ in this analysis may not capture some other aspects that regard the supervision of the financial system. On the basis of some data from the Institutional Profiles Database,\textsuperscript{11} that refer to the transparency of the banks accounts and the compliance with the rules, it is clear that Cyprus lags behind the EU average and even Greece (Table 5). The index is between 1 and 4, with 4 being the index of best performer. The relatively weak system of supervision may explain the bloating of the banking system and the high indebtness of the private sector.

\textsuperscript{11} This is a basis for institutional indicators published by the “Agence Française de Développement”. For details see Bertho (2013).
The question that arises is whether the adjustment process in the two countries will be influenced by the quality of their institutions. As we have already mentioned, the most recent forecasts indicate that the recession in Cyprus will be rather deep, but the period of recession seems to be shorter than in Greece. It is therefore, a matter of time, to see if the much better institutional framework of Cyprus will help the country to soon overcome the economic crisis.

4. Setting up better institutions and governance

From the above presentation it is clear that Greece, in addition to the macroeconomic measures needed for fiscal adjustment, growth and the restoration of competitiveness, must improve its institutional framework, and set up new governance mechanisms that will help the government to effectively implement macroeconomic and structural policies. From an economic policy viewpoint it is not sufficient to acknowledge that institutions do matter. It is also necessary to identify the determinants of institutional quality. This is a crucial task in order to implement policies aimed at building better institutions, and by doing this, promoting the recovery of the Greek economy.

Troika, since the beginning of its surveillance, has put forward and insists on the implementation of a broad ranging agenda of structural reforms. Most of the proposed reforms are in the areas of liberalizing markets, rationalizing the functioning of the public sector, deregulation and privatization. Other measures aim at reforming public administration, strengthening expenditure monitoring mechanisms for local governments and social security funds, setting up independent authorities, and introducing new auditing and governance mechanisms. There is little doubt that one sign of weak domestic institutions is the rather limited
involvement of domestic policy makers in setting up the agenda of needed reforms from a national viewpoint and ensuring their implementation.

With regard to institution building and improving public governance, the success is rather limited. It is true that some progress has been made, particularly in the area of tax administration, in the reorganisation of the General Accounting Office, and the Hellenic Audit Court. However, it seems that it will take time for these reforms to yield results. This may be due to the fact that troika and the special Task Force that has been set up by the European Commission for offering technical assistance in the area of reforms, have not taken into account the political constraints, and the limited capacity of the Greek public administration for reform. Making public administration leaner does not make it more efficient. Moreover, a number of reforms in the areas of taxation and public sector management were made on the experience of advanced industrial economies, which could not be implemented effectively in Greece, because of its weak institutions and governance mechanisms. As a result the tax system has become more complex and less equitable, and the public administration less efficient. This seems to confirm Acemoglu (2008) who very eloquently notes that:

“Exporting good economic institutions is as hopeless as exporting democracy. Institutional reform is essential for many societies to unleash their growth potential and it can happen as exemplified by successful cases of institutional reforms ranging from South Korea to Botswana. But such reform must have internal driving forces and what types of reforms can be successful will vary from country to country”.

Another factor that may have affected negatively the institutional reforms is that in the sphere of public space there are well organized groups that resist to changes. It is well known that these changes create winners and losers, but the winners do not usually take the streets to seek for support, while the losers, being more militant, easily become a barrier to changes.

For Cyprus the need for institutional reforms is not as pressing as in Greece, and according to the recent troika progress report, the main areas for reform are in the fiscal governance structures and the public administration. Yet, the relative performance of Cyprus in critical areas, like tax administration, functioning of the justice system, and ease of doing a business, is much better than in Greece and above the EU average, as revealed by the indicators (Figure 13) published by the Institutional

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12 For the progress of structural changes a good source are the quarterly reports of the Task Force for Greece, that operates under the auspices of the President of the European Commission, and its Head is Horst Reichenbach.

Profiles Database. According to these data Greece is still quite behind the EU average, while Cyprus seems to have an inferior performance only in the area of tax administration, and the need for its improvement is stressed in the troika reports. Of particular interest is the indicator for the capacity for state reform i.e. the administrations' ability to decide and actually implement reforms. Despite the efforts that have been made by the Greek authorities to change the functioning of public administration, the success, at least until 2012, were limited. The same is true for the reform of tax administration, and the ease of starting a business. This slow progress may be an indication of the difficulties in reforming institutions, as we mentioned earlier, and of the fact that reforms in the area of public governance take time. The slow progress seems to confirm the finding that the recovery process may be longer in countries with weak institutions.

FIGURE 12
Selected indicators of institutional performance (1-4 best)

5. Concluding remarks

The international economic crisis has affected asymmetrically different countries. Two countries that have been hit by the crisis are Greece and Cyprus. The causes of the crisis are different in the two countries. In Greece it stemmed from the public sector, with the high level of public
debt and the mounting general government deficits that accumulated over the years after Greece joined the Euroarea. In Cyprus the cause of the crisis came from the overexpansion of the banking sector and the high debt of the private sector. Because of the crisis, both countries were cut off from the international markets, and they were subjected to rescue packages jointly funded by the IMF, the EC and the ECB (known as troika). These packages include not only macroeconomic measures for fiscal adjustment and restoration of international competitiveness, but also measures for structural reforms. Of course, the initial conditions for these reforms are different in the two countries.

In this paper we have attempted to explore the effects that institutions and governance mechanisms may have on the process of fiscal adjustment and the restoration of international competitiveness. There is, by now, a large number of studies that confirm the view that institutions and governance affect significantly the long term performance of an economy. Moreover, there is evidence that the low quality of institutions may retard the economic recovery in countries hit by economic crises. On the basis of these findings, we have attempted to examine the structure of basic institutions and governance mechanisms in Greece and Cyprus, and to see how they may affect the adjustment process of the two countries, after the rescue packages initiated by troika.

Looking at the macroeconomic data, we observe that Greece entered a prolonged period of deep recession in 2009 and it is expected that there will be a slight recovery in 2014. Cyprus entered a recession in 2012, and although deep, it is expected to be much shorter. What we argue in this paper is that the length of the adjustment period is not due only to the very restrictive macroeconomic policies, but also to the fact that the basic institutions and public governance mechanisms in Greece are of much lower quality than in Cyprus.

Based on indicators for public governance developed by Kaufmann, D., Kraay, A., and Mastruzzi, M (2011), and on data for institutional quality published by the World Economic Forum (world Competitiveness Report, various issues), we find that institutions and governance in Cyprus are of much higher quality than in Greece. This is also recognised by troika, and the reforms it has suggested to Greece are much more thorough and pervasive than in Cyprus. What is interesting to note for Greece, is that despite the efforts for reform that have already been undertaken since the beginning of the crisis, the quality of institutions and governance mechanisms has deteriorated during the crisis. In Cyprus, although the recession is rather recent but also quite deep, the quality of governance remains quite high and higher than the EU average for the years of crisis. Given that institutions play an important role in creating political and
economic incentives, and help in solving problems of coordination failures, we may argue that the unexpected prolongation of the recession in Greece is due, to a great extent, to the weakness of its institutions and the poor governance mechanisms.

It is probably premature to draw any definitive conclusions on the effects of institutions and governance on the capability of a country to exit from a deep economic recession. Based, however, on the existing evidence, we do not take a high risk in predicting that the high quality institutions in Cyprus is a factor that plays a critical role in the efforts of the country to recover from the deep recession. For Greece, the protracted period of recession has confirmed the limited capacity of the state structures to effectively implement the required adjustment policies, and to remove the barriers that for many years impede the private sector to undertake new investment and the public sector to reduce waste, tax evasion and corruption.

Finally, we have to add that comparing the two countries’ exit paths from the crisis is further complicated by at least two considerations. First, the starting point was very different. Greece had a much higher fiscal deficit and the dramatic cuts in public expenditures contributed to the deep recession. Cyprus, on the other hand, faces a much greater problem in the banking sector. Second, the external environment is very different. Greece went through its adjustment when the entire world was in recession. Cyprus is facing a much more favorable external environment, which makes things easier.

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