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Cutting the Corruption Tax in Greece

By Paul Romer

Many of us take it for granted that government officials will obey the law. Here in the United States, news that the police department in New Orleans committed and covered up crimes like rape and murder reminds us that this needn't be the case. It also reminds us that living with the lawlessness of a weak state might be better than living under a strong state that officials can abuse.

Many nations live with a weak government because people fear that a strong government will abuse its power. This fear is particularly acute in a country like Greece, where

people can still remember the time in the late 1960s when military officers seized control of the state and brutally suppressed dissent.

Unfortunately, the current economic crisis in Greece is too serious for its weak state to manage. In New Orleans, the mayor and community leaders asked the federal Department of Justice to intervene and reform the city's dysfunctional police department.¹ Like the city government in New Orleans, Greece needs to reach out for help.

An aching slow recovery from the financial crisis could

continued on inside...

About The Author

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1. Robertson, Campbell. "Justice Department to Review New Orleans's Troubled Police Force." The New York Times, May 17, 2010. http://www.nytimes.com/2010/05/18/us/18orleans.html?_r=1&scp=1&sq=new%20orleans%20police&st=cse.

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threaten the foundations of Greek society. To avoid this the people of Greece should reach out to the European Union (EU)—not for more loans or for budget supervision but for assurance that new efforts to root out corruption and civil service inefficiency will be politically neutral. By working with the EU, Greece can quickly build the kind of strong, honest, and efficient state that can lead the country out of the crisis.

The Situation in Greece

Corruption and bureaucratic inefficiency amount to a tax on all firms that operate in Greece's formal sector. The tax is especially onerous for startups and foreign firms that would like to invest there.

Here's how one business leader, call him John, described a recent encounter with a local official. The official withdrew the license of one of John's operations. It would be reinstated only if John agreed to hire the official's girlfriend as a consultant and pay her via an offshore account. John's legal recourse was limited—any case

against the official would linger in the courts indefinitely. In the meantime, John's firm would not be able to operate without the license. John ended up speaking to someone higher in the government to get the local official to back down. He did not say what the higher-level official got in return.

This kind of behavior is not a secret. In Transparency International's CPI (Corruption Perceptions Index) rankings for 2009, Greece tied Romania and Bulgaria for the worst score in the EU. At this level, corruption has visible effects on the overall efficiency of government.

Daniel Kaufmann points to a strong correlation between corruption and fiscal deficits, even in industrialized countries like Greece. The budget position in Greece suffers from tax evasion and the political patronage that bloats public payrolls with unnecessary hires.² With levels of corruption comparable to Spain (hardly the gold standard), Greece's budget shortfalls over the preceding five years would have averaged as little as 2.5 percent of GDP rather than 6.5

percent, suggests Kaufmann.

As Marcus Walker points out in the *Wall Street Journal*, roughly one-quarter of all taxes owed in Greece are not paid. Walker also notes Prime Minister George Papandreou's frustration with the many Greek politicians who promise public administration jobs to constituents to secure votes. The finance ministry estimates that the government added 27,000 people to its payrolls in the run up to the fall 2009 election, even though many of the new hires lacked an official position and an office.³

The costs of patronage go far beyond the salaries for unneeded civil servants. In a work environment where political patronage trumps merit, employee discipline is slack, government agencies are poorly run, and graft is widespread. One particularly important failure lies in the judicial system, which is notoriously slow at resolving cases. As the local official who demanded the payments to his girlfriend understood, this dramatically broadens the opportunities for criminal activity.

2. Kaufmann, Daniel. "Can Corruption Adversely Affect Public Finances in Industrialized Countries?" Brookings Institution. http://www.brookings.edu/opinions/2010/0419_corruption_kaufmann.aspx.

3. Walker, Marcus. "Tragic Flaw: Graft Feeds Greek Crisis." *Wall Street Journal*, April 15, 2010. <http://online.wsj.com/article/SB10001424052702303828304575179921909783864.html>.



The business official who spoke to me earns a living by collecting part of the corruption tax. Foreign firms invest in Greece through his companies. He manages the demands from the officials. But his efforts come at a cost. Using data from global firm-level surveys, Kaufmann and Shang-Jin Wei find that the managers of firms that pay more in bribes are likely to spend more time, rather than less, quibbling over red tape with bureaucrats than firms that refuse to pay bribes. They also find that bribers have a higher cost of capital.⁴

The Benefits From Eliminating the Corruption Tax

Corruption and bureaucratic inefficiency act like the worst kind of tax—one that deters economy activity without raising any revenue. In the midst of the current crisis, cutting this tax would be a triple-win. In the long run, it will raise potential output. In the medium run, it will narrow the current account deficit by reducing the cost of producing goods in Greece. In the short run, it will encourage investment by foreign firms

and startups, which will bring the economy back toward full employment.

The existing approach, based on fiscal tightening, can reduce the budget deficit and, by temporarily reducing imports, help balance the current account. Some commentators suggest that a longer recession may be an unwanted side effect. In fact, prolonged recession is an essential part of this approach to reducing the current account deficit. If Greece relies solely on fiscal tightening, a long and deep recession will be the only way to drive wages low enough to permanently change the costs of production in Greece relative to its trading partners.

To avoid the need for a long recession, many countries enact adjustment programs that combine fiscal austerity with a cut in the exchange rate. Because it is part of the Eurozone, Greece does not have this option. In this context, the tax from corruption and inefficiency is an opportune obstacle—by removing it Greece can cut costs and become a more competitive place to do business. We don't know the exact magnitude, but this tax

cut might be large. A young person who is trying to grow a new business told me he would happily pay a 15 percent increase in the VAT if he could deal with a government that was as honest and efficient as the government in Hong Kong.

The Experience in Hong Kong

Until recently, Greece had five layers of government instead of the three levels—local, state, and national—that are standards elsewhere. The extra levels of government increase opportunities for corruption and inefficiency, so the current administration has wisely chosen to consolidate. But even with fewer levels of government, corruption and inefficiency will linger in those that remain.

Some say that corruption and political cronyism are an inevitable part of “the Greek reality.” As long as there is government in Greece, there will be a tax from corruption and inefficiency. In the 1970s, the same sorts of cultural pessimists thought that Hong Kong would always be corrupt. The actual experience there demonstrates just how wrong they were. Feasible

4. Kaufmann, Daniel, and Shang-Jin Wei. “Does Grease Money Speed Up the Wheels of Commerce?” World Bank Policy Research Working Paper No. 2254, 1999.

policies can quickly change a culture of corruption.

As in many places, the responsibility for fighting official corruption in Hong Kong once rested with a special branch within the police force that was conveniently ineffective. In 1974, the governor general of Hong Kong vested anti-corruption responsibilities in a new elite ministry, the Independent Commission Against Corruption (ICAC). The commission was directly responsible to the governor general, who was himself an appointed rather than an elected official.

The governor general in Hong Kong was not an authoritarian leader. He answered to the democratically elected British prime minister but his position did not depend on local political contests. As a result, neither the governor general nor the commissioners that answered to him had any interest in using the substantial powers of the commission for narrow political gain. They could be trusted with strong powers because they were held accountable to an offshore democracy that wanted Hong Kong to thrive.

Unsurprisingly, the ICAC's efforts met with considerable resistance from the police. The governor general was eventually forced to grant amnesty for past crimes after the police went on strike and threatened violence. Though amnesty was viewed as a setback at the time, it meant that the commission could use all of its resources to prosecute fresh cases involving corrupt police officers and officials. This made it a much better deterrent against continued corruption.

Along with the formal prosecutions, the ICAC used education to change Hong Kong's social norms regarding corruption. It organized a broad campaign, adding anti-corruption classes to the public school curriculum and creating anti-corruption television programming. It published surveys that tracked changes in the amount of corruption over time. The commission also reviewed the rules of all ministries and modified them to reduce opportunities for corruption.⁵

So much for Hong Kong's intractable culture of corruption. According to the surveys, the frequency of requests for bribes fell very quickly. Today Hong

Kong is among the least corrupt places in the world, ahead of countries like Japan, the United Kingdom, and the United States.

Guns at a Fistfight?

If a commission like the one in Hong Kong could eliminate the corruption tax in Greece, and if doing that would be so beneficial in the midst of the current crisis, why hasn't one been established there? The problem is as old as Greek democracy. As Plato observed, if guardians are how we prevent lawlessness, who guards the guardians?

Government agencies that are strong enough to prosecute corruption cases and root out inefficiency in the civil service will also be susceptible to abuse. Selective prosecution and civil service dismissals could easily be used to help one political party and hurt another. Even if these powers are used in a neutral way, those who are caught will claim that the motivation for their prosecution was political. Unless such repeated assertions can be decisively rebutted, they could undermine the commission's legitimacy.

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5. Manion, Melanie. *Corruption by Design*. Cambridge: Harvard University Press, 2004.



Political competition in Greece is like a fistfight in a bar. Creating a powerful new commission would be like tossing a gun into the middle of the brawl. All parties remember how strong state powers were abused during the military takeover. Left on their own, they might reasonably agree that new powers would be destabilizing and dangerous. But given the chance, they might still want to invite a new sheriff to town.

Bringing in the European Union

Because of its membership in the EU, Greece has an option that is not available to most other countries in the world. By leveraging the credibility of the EU, Greece can begin the same sort of transformative fight against corruption that Hong Kong embarked on in the 1970s. If the EU can ensure that the appointment process to an anti-corruption commission is free of political influence, Greeks could remove the corruption tax without disrupting the political equilibrium.

The process could be structured in many different ways. For example, Greek political parties and members of civil society could propose names for head anti-corruption commissioner. The president of the EU

could then make an appointment from the list, retaining the power to remove, replace, or reappoint the commissioner. Like a central banker, the head commissioner could have a clear mandate and wide discretion for achieving it, particularly in hiring and firing commission staff. The mandate could focus on the future, following the example of Hong Kong and specifying amnesty for past corruption.

The involvement of the EU could expire with a sunset clause. The clause might be based on a supra-majority vote in a referendum. The clause could also be triggered by objective indicators of performance, such as Transparency International's Corruption Perceptions Index or the World Bank's Control of Corruption measure.

A similarly independent commission could bring the most basic elements of management to the Greek civil service. A civil service commission could end the practice of hiring and promotion based on political patronage. People who do their jobs would be rewarded. People who don't would be advised to change, counseled out, or fired. With this kind of approach, essential government organizations

like the courts and tax agencies could actually perform their functions.

What's At Stake

The fate of the entire EU project—to improve all aspects of governance in its member states—hinges now on how the crisis in Greece is resolved.

Proposals for centralized oversight of EU member-state budgets are both too hard to implement and too narrow in their focus. The proposals outlined here, independent commissions that promote honesty and efficiency in government, could be implemented quickly and would be far more helpful. They can be prototyped in a way that is specific to the situation in Greece, then adapted to other countries as necessary.

Many well-established democracies in the EU have solved the problem of guarding strong guardians. Through the institutions of the EU, they can assist people who still live without the remarkable benefits that this can offer, just as the federal government in the United States can assist the people of New Orleans. In Greece, as in New Orleans, all it would take is for the local government to ask.

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