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Ioannis Vavouras, Maria-Eleni Syrmali

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Scientific Society for Social Cohesion & Development - EPEKSA
12, Klisovis Str. Athens 10677, Greece
Tel: +30 210 3303060, Fax: +30 210 3801777
www.epeksa.gr, e-mail: info@epeksa.gr

The Greek Debt Crisis under the Spectrum of Institutional Analysis: The Role of Governance and Social Development

By Ioannis Vavouras[1], *Maria-Eleni Syrmali*[2]

Abstract

The main approaches of the New Institutional Economics provide a prominent position to an institutional theorization of the economy. Under this spectrum, the deeper causes of the Greek debt crisis may be explored as a reflection of its economic, political and social systems and the way they are interlinked. A better understanding of the more fundamental determinants of this issue could result in the long-run management of economic policy problems, so that the selected policy means may be compatible with the potential, the constraints and the structure of the economy, as well as the broader social and political environment under which it operates. In consequence, the sustainable handling of the debt crisis could be reached through the achievement of efficient institutional reforms that can lead to economic and social transformation. Within this analytical framework, it is supported that a sustainable perspective of economic issues in general and of the debt crisis in particular requires the development of the economic, social and political institutions. This is basically the substance of development itself, which should not only focus on its economic dimension, but on the social and political as well.

Key words: Institutions, governance, debt crisis, social development.

[1] Professor of Economic Policy, former Rector, Panteion University of Social and Political Sciences.

[2] PhD Candidate, Panteion University of Social and Political Sciences.

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Corresponding author: vavouras@panteion.gr

1. Introduction

International differences in economic prosperity are astonishing while developed countries are the exception and not the rule. A handful of countries manage to engineer rapid economic growth after years of stagnation, others stagnate after a period of high economic growth, yet others have never experienced sustained growth[3]. Moreover, crises and failed transition experiments in the 1990s brought to light that even the conventional policies for promoting economic growth, such as fiscal discipline, reorientation of public expenditures and tax reform, are doomed to fail in terms of desired living standards in the absence of well functioning institutions[4]. A better understanding of what generates economic growth and what could be done in order to improve the living standards in a society could make a huge contribution to human welfare.

Based on this analytical framework, it should be pointed out that sustainability in terms of development refers to the expansion of income as well as to large-scale economic and social changes[5]. Therefore, a prominent role should be given to institutions and rules that shape economic behavior. In consequence, the quality of the institutional environment determines to a large extent the prospects of the economy. However, according to the World Bank (2000), apart from focusing on economic issues, work on institutional reform is required, which inevitably involves social and political considerations. As a result, the economy should not be examined isolated from the broader sociopolitical environment within which it operates.

These developments gave impetus to a discussion that distinguishes between "proximate" and "fundamental" causes of growth. The "proximate" causes of

[3] Rodrik (2007).

[4] World Bank (1998).

[5] Vavouras (2011).

growth relate to factor inputs that directly take part in the production process, such as capital and labour, and to variables which influence the productivity of inputs, such as scale economies and technological change. The "fundamental" sources of growth relate to those variables, which have an important influence on a country's ability to accumulate factors of production and invest in the production of knowledge. According to this line of thought, much of the economic literature (e.g. standard economic models of factor accumulation and endogenous technical change or progress) provide proximate explanations of comparative growth, largely neglecting fundamental institutional causes (Acemoglu, Simon and James, 2005).

The rest of the study is organized as follows. Section 2 explores the concept of institutions from an economic perspective and its interlinkages with the notion of governance. Section 3 presents an institutional perspective of the Greek debt crisis. Section 4 discusses the conclusions and some major policy guidelines.

2. A theoretical analysis of institutions

The institutional theorization of growth, according to which the interconnection between institutions and the economy is prevalent, dates back to classical economists, like Adam Smith and John Stuart Mill, as well as some neo-classical economists, like Alfred Marshall. In the history of economic thought, there have been some relevant attempts so as economic theory to incorporate institutional analysis. The most characteristic example is the so-called "Old Institutional Economics"[6], which started to flourish at the end of the 1890s in the United States of America. The Old Institutional Economics School recognizes the social and cultural basis of the economic phenomena and supports the view that

[6] The term institutional economics is attributed to Hamilton (1919).

economic behavior is affected by the broader spectrum of social rules και psychological archetypes[7]. A prominent position in this School hold Thorstein Veblen, Wesley C. Mitchell, John R. Commons. However, due to the fact that it did not manage to establish a concrete framework of analysis via the development of the appropriate theoretical modeling and mathematical tools, the Old Institutional Economics School was soon abandoned in the first half of the 20th century.

The academic interest about the way institutions work within the framework of economics has been initiated more recently by Institutional Economics, which combines tools and hypotheses from the classical thought, the neoclassical economics as well as the Marxist theory (North, 2000). A principal argument of this School is that institutions are not exogenous and given a priori but, on the contrary, they constitute endogenous restrictive frameworks and tools for economic growth[8].

More specifically, the debate on institutions has been propelled to the top of the economic research agenda after the contribution of Nobel Laureate Douglass C. North. According to North (1990), "institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction". In the same study, North goes on emphasizing the importance of institutions, saying that "they (institutions) structure incentives in human exchange, whether political, social, or economic". This definition encapsulates three salient features of institutions (Acemoglu, 2009). Firstly, institutions are humanly devised, in contrast to other fundamental factors like geography, which are outside human interference. Secondly, institutions set constraints on human behavior, even though these constraints do not need to be unassailable as any law or regulation can be ignored. Thirdly, institutions are considered to shape incentives, much more than the other candidate fundamental causes.

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[7] For an overview of the relevant literature, see Rutherford (2000).

[8] For an overview of the literature, see Langlois (1986), Eggertsson (1990).

According to North (1990) institutions may be formal or informal. Formal institutions consist of formal written rules and include political (and judicial) rules, economic rules and contracts. Informal rules refer to customs, traditions, cultural constraints, norms of behavior, conventions and codes of conduct. Within this framework, the discrimination between formal and informal rules is important, as some countries may have the same formal institutions, which, nevertheless, might operate in a totally different way due to the existence of informal rules. Formal rules might change in the short-run as a result of political or judicial decisions, while informal rules are more resistant to changes and evolve gradually until they are assimilated by society. As a result, the interaction between formal and informal rules and of their structural characteristics, the way they unfold and the means of their enforcement shape institutions and the way they operate.

2.1 Institutions and organizations

According to North (1990), a crucial distinction is made between institutions and organizations. Conceptually, what must be clearly differentiated are the rules from the players. Institutions, as already denoted, are the rules of the game, whereas organizations are the players. The purpose of the rules is to define the way the game is played. The objective of the team within this set of rules is to win the game by a combination of skills, strategy, and coordination. Organizations are groups of individuals bound together by some common objectives. Separating the analysis of the rules from the strategy of the players is a necessary prerequisite to build a theory of institutions. Organizations include political bodies (political parties, the Senate, a city council), economic bodies (firms, trade unions), social bodies (churches, clubs, athletic associations), and educational bodies (schools, universities).

When the cost that emerges as a consequence of the institutional framework is examined, it is apparent that it is the result not only of that framework, but also of the organizations that have developed as a corollary of that framework. Both the organizations that come into existence and the way they evolve are fundamentally influenced by the institutional framework. In turn they influence the evolution of the institutional framework. Organizations are created to take advantage of the opportunities provided within a given institutional framework and as they develop they alter institutions themselves. So, in the course of attempts to fulfill their objectives, organizations are a major agent of institutional change. Therefore, it is the interaction between institutions and organizations that shapes the direction of institutional change. As a result, institutions together with the standard constraints of economic theory, specify the opportunities in a society.

2.2 Economic analysis of institutions

The institutional framework affects economic growth because it is integral to transaction and transformation costs related to the production process (Aron, 2000). Transaction costs, for example, are far higher when property rights or the rule of law are not reliable. In such situations private firms typically operate on a small scale and may rely on the hidden or underground economy and corruption to facilitate their activities. Transaction costs are higher when the rules are not well defined and in such situations private firms typically operate on a small scale and may rely on the shadow economy and corruption to facilitate their activities whereas high bureaucratic costs discourage investments. Transformation costs, too, can be raised substantially because unenforceable contracts mean using inexpensive technology and operating less efficiently and competitively on a short-run horizon. The protection of property rights reduces uncertainty and externalities whereas it creates steady expectations through the existence of stable rules and structures in transactions shaping incentives for investments. As a result of concrete institutional building, economic units invest more capital and develop their technology whereas they use these inputs more efficiently while expanding their activities.

To sum up, when institutions are poorly defined economic activities are restricted to interpersonal exchanges. In such cases, repeat activities and cultural homogeneity facilitate self-enforcement. It is clear, however, that firms or agents in an environment of weak institutions cannot engage in complex, long-term, and multiple-contract exchanges with effective enforcement as they do in developed economies where the prevalence of formal institutions is the norm in everyday transactions.

2.3 Institutions and governance

Institutions and the quality of governance are closely interlinked. It must be pointed out that governance is a broad, multi-dimensional concept. As a result, an internationally agreed definition of governance does not exist (Commission of the European Communities, 2003). Therefore, international agencies and researchers follow their own definitions depending on the conceptual perspective under which they analyze the notion of governance.

According to the OECD (1995), governance denotes the use of political power and exercise of control in a society in relation to the administration of its resources for economic and social development. Moreover, good governance refers to the rule of law, efficient public sector management and corruption control.

The European Commission's definition of governance refers to the state's ability to serve the citizens. The way public functions are accomplished, public resources are managed and public regulatory affairs are conducted is the major issue to be addressed in that analytical framework. Despite its open and broad character, governance has a practical value related to the basic aspects of the operation of any society and political and social system and in this respect it can be characterized as a basic measure of stability and performance of any political and administrative system. Thus, institutional sustainability and capacity building are the primary elements of the good governance agenda (Commission of the European Communities, 2003). In consequence, governance penetrates in all areas of economic and sociopolitical life and considers governance, policy formulation and implementation closely interconnected.

According to the United Nations Development Programme (2007), governance is the system of values, policies and institutions by which a society administers its economic, political and social matters through synergies within and among the state, civil society and private sector. It describes the rules, institutions and practices that set limits and provide incentives for individuals, organizations and firms. Despite the plethora of definitions of governance in the literature, it is possible to distinguish three fundamental types of governance. First, the political or public governance, the authority of which is the state, the government or the public sector and concerns the process by which the society manages its affairs. Second, the economic governance, whose authority is the private sector and relates to the policies, the processes or organizational structures that are necessary to produce and distribute services and goods. Third, the social governance, whose authority is the civil society including citizens and non-for-profit organizations and which is connected to a system of values and beliefs that are indispensable for social behaviors to be materialized and for public decisions to be made. As can be extracted from this definition, governance permeates all areas of economic and sociopolitical life and considers governance, policy formulation and implementation tightly intertwined.

One of the most widely used definitions of governance in the literature is provided by the World Bank. Governance is, thus, defined as the traditions and institutions by which authority in a country is exercised (Kaufmann, Kraay and Zoido-Lobatón, 1999). According to this definition, three dimensions of governance are prevalent[9]: (i) the political dimension, which refers to the process

[9] See, Kaufmann (2005).

by which those in authority are selected, monitored and replaced, (ii) the economic dimension, which refers to the government's capacity to effectively manage its resources and implement sound policies, and (iii) the institutional dimension, which refers to the respect of citizens and the state for the country's institutions.

Good governance refers to the processes and structures that guide political and socio-economic relationships (United Nations Development Programme, 1997). Therefore, attaining and sustaining good governance is not a one dimensional process, whereas a coherent policy framework should be adopted due to the complex nature of the concept. Good governance is a useful tool to respond to collective problems. It promotes participation in social affairs, transparency, accountability and equity. It strengthens democratic political institutions, the rule of law, effective administration, social cohesion and is viewed as a prerequisite to the maintenance of confidence in public institutions.

According to the previous analysis, it is evident that governance expresses the level of institutional quality in a country. So, it must be emphasized that in terms of economic growth and development governance relates to the basic elements of the broad cluster of institutions (Acemoglu, 2008). Defined as such, important elements of governance would include the political institutions of a society, which refer to the process of collective decision-making and the checks on politically powerful interest groups. In addition, they incorporate state capacity, which refers to the capability of the state to provide public goods in diverse parts of the country and the regulation of economic institutions, which refers to the way the state intervenes in encouraging or discouraging economic activity. As a consequence, the interrelated links between institutions, formal as well informal, and economic growth is ultimately linked to the relationship between governance and growth. Therefore, from a development perspective, governance issues are inseparable from the ways and means to promote institutional reforms and induce a profound institutional change (Bonaglia, Braga de Macedo and Bussolo, 2001).

3. An institutional perspective of the Greek public debt crisis

Since governance and the relevant notion of institutions relate to the exercise of governing power, they are closely connected with the economy and the act of policy making. Based on this analytical framework, in order to tackle the most pressing economic problems, its fundamental causes should be explored. Under this spectrum, the most prominent causes of the Greek debt crisis should be analyzed. It should be, also, pointed out that the current economic policy problems are usually the result of past policy actions, especially when their causal factors are stock variables, which follow an accumulation procedure. This is the case of public debt, which mainly consists of past deficits that are agglomerated. As a result, if these problems are not accompanied by policy actions in order to deal with them, their characteristics become structural, which makes the fight against them even more difficult.

According to this line of thought, in the following paragraphs the deeper determinants of the Greek debt crisis are presented[10], which are not only of economic nature but of sociopolitical character as well. Based on this premise, the institutional deficiencies of the public sector in Greece should be emphasized.

The Greek public sector is characterized by bureaucratic delays and obstacles, which result in increases in the cost function. The low productivity of the public sector is not only determined by the bureaucratic way of operation, but it is also affected by additional structural weaknesses, as corruption and meritocracy. In these cases, the dominant principles of good governance, as described earlier, are violated.

Another determining factor of the Greek debt crisis is the rising size of the underground or shadow or hidden economy[11]. The extensive increase in

[10] For an extensive analysis of the basic determinant factors of the Greek debt crisis, see Vavouras (2013).

[11] For a comprehensive overview of the relationship between the debt crisis in Greece and

the underground economy is mainly a combination of the limited efficiency of the public sector, which defines the opportunities to develop such action, and the low level of social development, which determines the motives to develop such behavior. The shadow economy basically constitutes a social problem as it is seriously affected by the degree of citizen's acceptance of public authority or the level of tax consciousness or even tax morality. The way citizens face public authority is mainly determined by the level of social development. If the level of social development is low and as a result social cohesion is limited, people usually are not eager to participate in the costs of public service.

Moreover, the problem of public sector deficits and as a result the public debt itself has an intense political character. Greece's public deficit is related to the existence of politico-economic cycles, which are the fluctuations of the economy before and after the (general) elections.

The different aforementioned aspects of the problem of public debt, namely the political, the economic and the social one, are mutually affected creating a vicious circle the exit from which proves to be extremely difficult. Moreover, when this exit is succeeded it proves to be temporary and not sustainable, as its causal factors are not encountered while exercising public policy.

Systemic weaknesses of the public sector, the expansion of the shadow economy and the followed political behavior through the creation of politico-economic cycles or political-fiscal cycles as basic factors of the debt crisis, are the result of the quality of governance. This includes upper-level political staff as well as lower-level bureaucrats, the behavior of which is mostly determined by the level of political and social development.

It must be pointed out that social development is concerned with the processes of change that leads to improvements in human well-being, social relations and social institutions that are equitable, sustainable and compatible

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the role of the underground economy, see Manolas, Sfakianakis and Vavouras (2013).

with the principles of democratic governance and social justice[12]. This definition emphasizes social relations, institutional arrangements and political processes that are central to efforts for achieving desirable development outcomes. From this perspective, the concept of social development moves beyond a singular focus on economic growth and material concentration (measured in terms of income or GDP), which are necessary for a decent living, towards an approach that integrates social, cultural and political achievements into the fundamental conceptualization, measurement and practice of development. Similarly, political development refers to the ability of governmental structures and processes to respond to social change (Nye, 1967). Therefore, political development depends upon social transformation. As a result, social development is a fundamental concept for sustaining economic development in the long-run.

As a result the quality of governance proves to be a critical issue for the sustainable treatment of the public debt crisis through the exercise of coherent, consistent and efficient and as a result a reliable economic and social policy. Under this spectrum, the goal of tackling the debt crisis as well as the selected means in order to achieve this objective should be feasible and compatible with the existing restrictions and the structure of the economy as well as the operation of the economic, social and political system. This constitutes the core matter of the so called issue "the morality of governance".

4. Conclusions and policy considerations

In developmental context, the existence of the institutional framework aims at reducing the uncertainty by establishing incentives and a steady framework in transactions. The institutional structure and quality are used as measures for qualifying the stability and the efficiency of state structures and administrative

[12] See, United Nations Research Institute for Social Development (2011).

systems. The significance not only of formal but of informal institutions as well has been emphasized in the analysis. In consequence, the efficiency of institutional systems can be succeeded only through the appropriate long-term policies, which should target at healing the structural character of the problem. As a result, the success of institutional reforms demands the existence of common beliefs on behalf of citizens and politicians as well as the acceptance of a new political culture free of serving personal interests. As a main determinant for improving the quality of institutions emerges the need for a deep change of the established political culture and social beliefs through a long-run strategy of political and social development. Without them, improvements in economic terms are unlikely to be sustainable over the longer-term.

Within this analytical framework, the goal targeting at the treatment of debt crisis and the means chosen for its achievement, should be attainable and compatible with the constraints, the structure as well as the function of the underlying economic and political framework. Also, the quality of governance proves to be a critical factor for the sustainable management of the debt crisis through the exercise of consistent and efficient and as a consequence reliable policy. Dror (2001) gives prominence to the morality of governance, while it is recognized that the quality, the motives and the character of the higher hierarchy of governance determine to a great extent the quality of governance, especially during periods of crisis. At a more fundamental level, improving governance depends to a great extent on the improvements of the political culture as well as the level of social development.

Sociopolitical development requires the acceptance on behalf of society of a new system of beliefs about the state and the political system, which should abandon their utilitarian character. Moreover, it presupposes a structural change of the established political culture, which can be gained through an appropriate long-run strategy targeting at improving social development. As a result, social development requires social transformation, which refers to the shift of the systemic characteristics of a society, which result in the improvement of the level of social consciousness and cohesion. However, it should be emphasized that improving governance quality is not the result of some exogenous to the society factors. It presupposes the development of society itself. This change cannot be the result of the influence of some coincidental factors but of the establishment of a specific and suitable national strategy of institutional reforms as well as of an extensive shift and redistribution of financial resources towards productive activities.

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