

The Greek crisis and small-scale production

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ABSTRACT

This paper offers an interpretation of the Greek crisis focusing on the role of small firms in Greek production. Most accounts stress austerity and interpret the crisis purely in macroeconomic terms, as linked to Eurozone membership. This ignores that EZ membership was itself proposed partly as an instrument towards structural change. To address the crisis, it is important to be clear on its causes. If one focuses on the structure of production and, in particular, on the role of small family firms, it is possible to offer an explanation spanning the entire period from the sixties – the transformation of Greece from an emerging economy to EU member and ultimately to the EZ problem child. Far from being an obstacle to growth, dynamic small firms in the past showed resilience and withstood major shocks – entry into the EU, globalization and EZ membership. The distinguishing feature of the present crisis- and the reason why exit is proving so difficult – is that small firms have been hit harder and have yet to recover. Moreover, misdiagnosing the crisis in exclusively macro terms, may make small firms' situation worse.

The paper conceptualizes a scheme with two types of small firms – one dynamic and outward looking - aiming to compete - and another defensive and inward faced–looking to the State for protection. The latter were key players in clientelistic political economy, while propping them up imposed burdens on dynamic firms and needed persistent borrowing. Dynamic firms were further persistently burdened by a version of the 'Dutch disease' – the impact of capital inflows in marginalizing efficient producers – providing a bridge between micro and macro considerations.

Recovery in Greece *without* dynamic small firms is only possible in the presence of an external *Deus Ex Machina* –in the form of foreign investment, debt relief or both. Reading the crisis as a crisis of production and not exclusively one of public finance is a first step towards setting a viable exit strategy. Ending austerity may be a necessary, but certainly not a sufficient condition. Industrial Policy towards small enterprise has a crucial role.

1. Introduction:

The Greek crisis has involved great effort and great pain. Yet, its handling is acknowledged as an exceptional failure. Seven years after the first bailout, Greece is trapped in a cycle of recession and vulnerability. After three bailouts, nine years of nominal GDP falls, record unemployment and wage cuts, there is still no end in sight. The dominant narrative is that Greece is in crisis and cannot recover because of an austerity programme that is externally enforced. The other side stresses problems in the programme's design and implementation.

Both sides concentrate on the treatment, but forget about why that became necessary in the first place. Our view is that there can be no exit, if the origins of the crisis are not addressed. Macroeconomic aspects (debt and austerity) are certainly important; an end to austerity must necessarily accompany recovery. Yet, an *exclusive* emphasis on macroeconomics is reductionist, and problematic - both analytically and politically. *Analytically* it is important to be clear about the origins of the problems rather than their manifestation. *Politically*, one needs a richer agenda that goes beyond the necessary step of debt relief, to address the weaknesses and vulnerabilities of the real economy. Our own starting point is that the Greek crisis has been misdiagnosed. Dominant accounts are missing a key ingredient; by doing so they are failing both in target setting and in implementation.

That ingredient, in our view, is the role of small firms in Greek production. Most accounts see a fiscal crisis and focus on the period from Eurozone membership. However, that was the result of production vulnerabilities, long manifest in Greece's development path. A macroeconomic and fiscal narrative of the crisis needs to be complemented with an appreciation of key features of production, namely of the different types of small firms. In this way, we add economic actors to a mechanistic aggregate analysis; a bridge between micro and macro issues, between competitiveness and public finance.

The missing actor is the small Greek family enterprise. The thread running through the country's long-term path is how these firms related to their environment. We need to see, in other words, how small firms dealt with globalisation, as well as how they accommodated the fiscal pressures from the State. Our explanation, outlined in Section 3, has two parts: A *microeconomic part*, which postulates the existence of two types of small family firms, dynamic firms not afraid to compete, and defensive firms trying to hide behind protection. This is complemented by a *macroeconomic part* which examines how the external and public sector financing balances are met and what this means for public expenditure and taxation. Growth and development are thus dependent on the balance between dynamic and defensive firms; the way this balance is mediated by the State explains much of the macroeconomic features of external and fiscal balance.

This paper meshes macroeconomic and micro-structural viewpoints in a single production-based narrative. Section 2 examines the consistent underperformance, of Greece during the crisis (most evident in exports), despite a full reform score card. Unlike previous crises, which were weathered by small firms, those firms appear trapped in this one. Section 3 outlines a conceptual framework linking the macroeconomy with small firms. This is put to work to explain pre-crisis developments, before going to ask why this time is different. The last section draws the lesson that, rather than wait for external salvation, the Greek economy must first deal with the problems of the small firm. The macro economy cannot recover so long as production problems remain unanswered.

2. The crisis in context: Causes and mechanisms

2.1. How to account for manifest failure?

Most accounts of the Greek crisis begin with the creation of the Eurozone in 2000. Framed this way, the mainstream narrative goes like this: the real issue that triggered the Greek crisis was a debt-financed growth bubble, inflated by EZ membership (Manasse, 2015). The easy flow of credit removed pressures to address structural problems. Beyond this narrative, there are three different ways of pointing the finger at exactly what was to blame for indubitable failure:

First, the architecture of the Eurozone predicated deflation: The innate problems of the common currency and incomplete institutions at EU level, encouraged tolerance of debt accumulation before the crisis and led to delays in crisis management at EU level. This led to a deflationary spiral (Manasse, 2015, Pisany-Ferry et al, 2013; Fernandez-Villaverde, Garicano & Santos, 2013).

Second, deflation resulted from problematic program design and other technical flaws: Miscalculations like the fiscal multiplier controversy (Blanchard & Leigh, 2013) are often cited, as were design flaws and sequencing of reforms. One such was proceeding with labour reforms ahead of product market liberalization. Finally, inefficient monitoring of program implementation is assigned some responsibility (Davras, 2015; Terzi, 2015; Mazzolini & Modi, 2014; Manasse, 2015).

Third, political economy and governance are to blame. Obstacles arising from internal politics fed blame games between the troika and the authorities. This encouraged lack of reform ownership, disregarded the limits of governance capacity and underestimated pressure groups' resistance. In this view weak institutions are ultimately to blame (IMF 2017, Papaioannou 2017, OECD? Papaconstantinou 2016).

These accounts are reductionist. In effect, they look at the efficacy of treatment, taking for granted what the treatment was *for*. Although, as descriptions of what happened they all have an element of truth, and can offer useful pointers for future improvements, they focus on the mechanics of the crisis. Improving delivery of the given programme would certainly help. However, programme improvements – despite early hopes – have proved repeatedly not sufficient. Following the third bailout in 2015, the spotlight is turning away from the Greek crisis, crisis managers are at a loss to propose something new that can succeed where other ideas failed. On the other hand, the ideas vacuum feeds the wholesale rejection of structural adjustment; this takes place under the rubric of 'anti-austerity politics' – practised with great aplomb by the SYRIZA government.

Our view is that the policy vacuum is due to ignoring a missing factor. Accounts of the crisis must encompass how it was caused; path dependence must be accorded an important role. Ignoring this leaves little prospect of possible ways out.

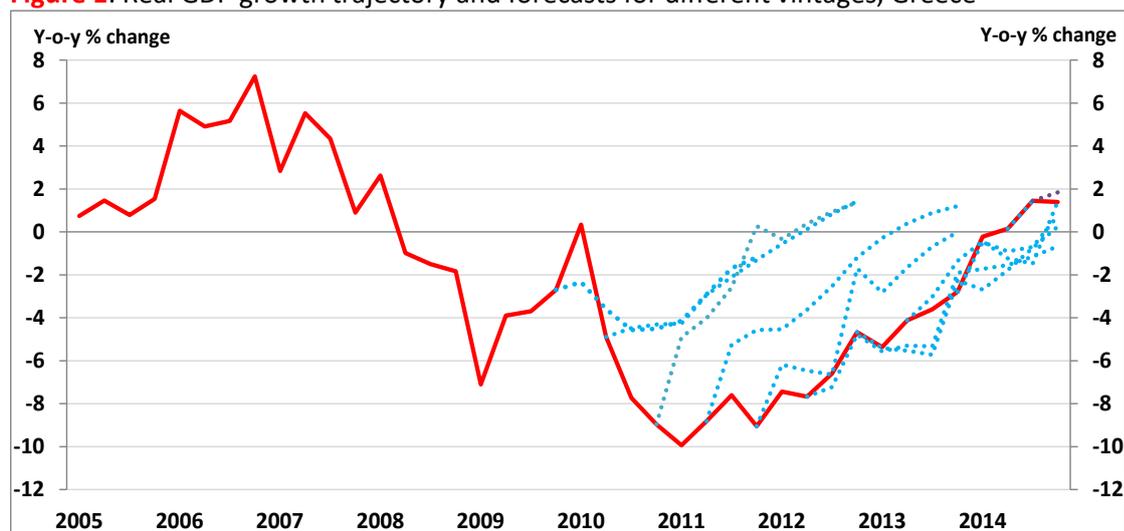
It is useful to recall that in Greece EZ membership was chosen as an instrument to address pre-existing structural problems. The Governor of the Bank of Greece in 2001, marking EMU entry, was clear that EMU entry meant *more* work for structural reforms, to meet the challenge of real convergence (Papademos 2001). Seen in this way, the key question is why, despite early intentions, did the EZ *not* prove to be the protected nursery in which to address structural fundamentals? The argument of this paper is that the Greek crisis is not so much a fiscal crisis as a *production* crisis. Starting from fiscal issues places the cart before the horse; missing this could explain some of the repeated failures.

The rest of the paper is structured around this narrative. We first look at how the crisis evolved to try to spot open questions in the explanation. We then offer a conceptual framework based on production. This is put to work to explain long term trends up to the crisis, and then the crisis dynamics themselves. This allows us to proffer some tentative ideas for a way out in the conclusion.

2.2. Some Puzzles of the crisis: A missing factor?

A 15-year long period of prosperity starting in the mid-1990s of the Greek economy led to a hard landing in 2009 and a rescue with a huge bail-out program by spring 2010. There was some early optimism that the program would act as a positive shock and allow Greece to exit the crisis within 2 years (Papaconstantinou 2016). This proved completely unfounded: There had to be *three* successive bail-outs (in 2010, 2012 and 2015), while there is already talk of fourth in 2018. The serial optimism is captured by **Figure 1**, showing that economy *consistently* undershot each vintage of expectations. *Could* this be due to missing a key ingredient in the explanations?

Figure 1: Real GDP growth trajectory and forecasts for different vintages, Greece



Source: OECD Economic Surveys: Greece 2016, page 67. OECD Economic Outlook 87 to 98 databases.

The macro-dynamics of the crisis are encapsulated in how twin deficits, one in government finances¹ and another in the external balances², interacted with the debt burden/overhang³. As a result, GDP collapsed⁴ and unemployment soared (**Figure 2**), while poverty and deprivation were very acutely felt. GDP per head fell by a quarter, while median income fell by 35.8% 2010-2014, leading to a sharp rise in material deprivation.⁵ Though deterioration after a point was less steep, 2016 was the ninth successive year of recession. The bailouts involved extensive fiscal adjustment, but also numerous structural reforms. Overcoming a slow start, the overall reform record is impressive. This is shown by macroeconomic indicators such as the reduction of fiscal deficits, the achievement of external balance or the reduction in labour costs. The reform scorecard— on paper at least — shows Greece top of the class - even taking on board implementation issue —weaker in Greece than elsewhere, (**Figure 3**). So, what went wrong?

¹ 15.6% of GDP in 2009 -from 4.5% in 2001

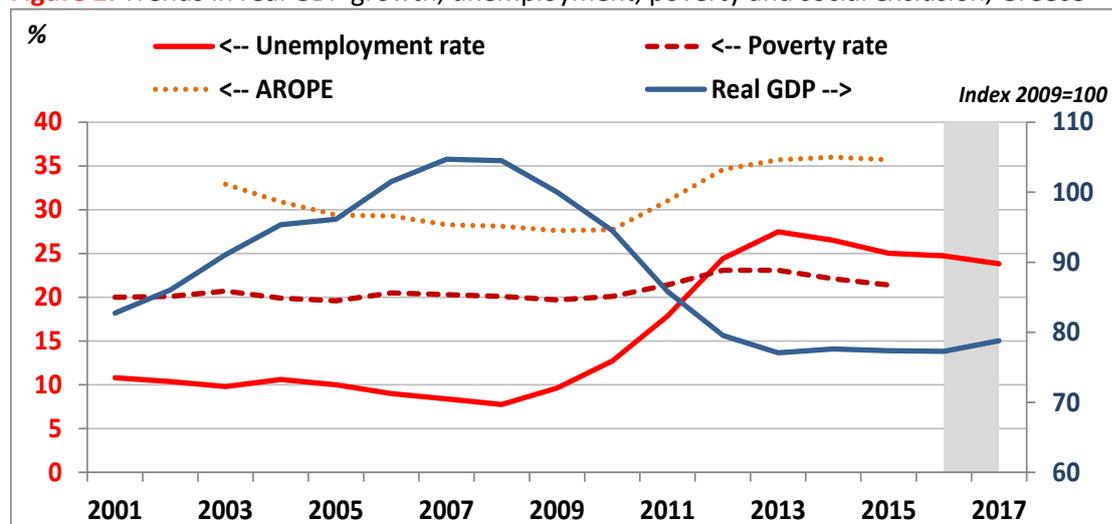
² from 7.2% in 2001 to 14.6% of GDP in 2009

³ Public debt as a % of GDP increased from 103.1% in 2007, to 126.8% in 2009.

⁴ In a macro-benchmarking exercise Gourinchas et al (2016) find that Greece's 25% drop in real GDP per capita between 2008 and 2014 was significantly more severe and protracted than elsewhere, while the collapse in investment (75% decline between 2008 and 2013) was even more severe.

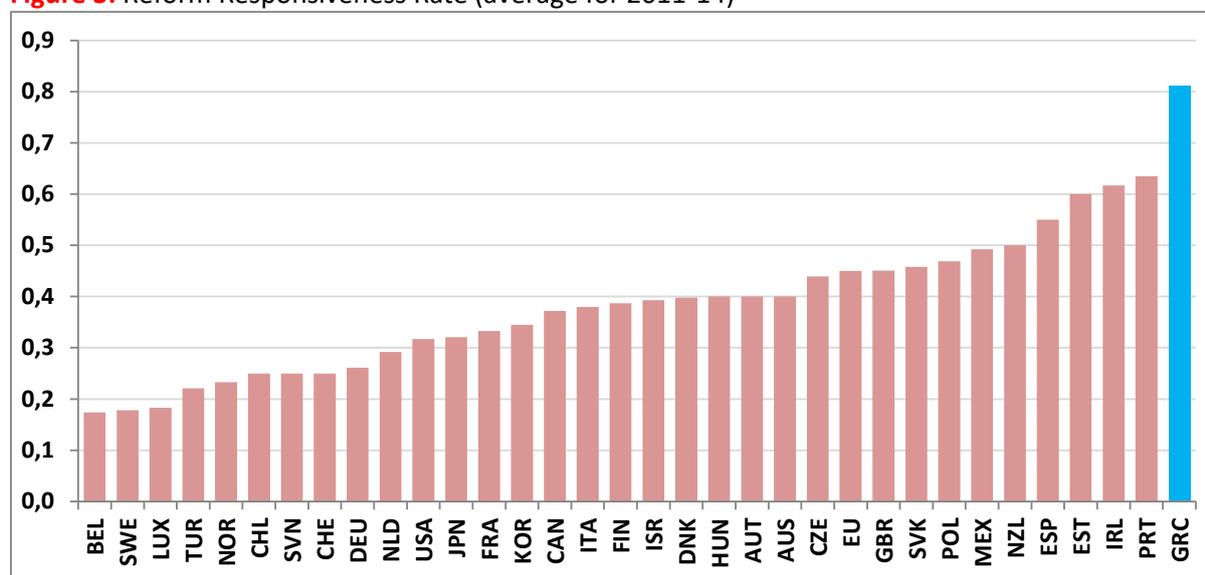
⁵ In absolute terms the poverty line fell from 6,100 EUR in 2007 to 4,600 EUR in 2014. As low incomes fell in line with the general level, *relative* poverty and inequality measures increased only modestly. The at-risk-of-poverty rate, increased from 20.1% in 2010 to a maximum of 23.1% in 2013; in 2014 it fell back to 22.1%.

Figure 2: Trends in real GDP growth, unemployment, poverty and social exclusion, Greece



Source: OECD Economic Surveys: Greece 2016, page 10; and Eurostat, LFS and EU-SILC data.

Figure 3: Reform Responsiveness Rate (average for 2011-14)



Source: OECD Economic Surveys: Greece 2016, page 66; **Note:** The reform responsiveness rate indicator is based on a scoring system in which recommendations set in the 2011 and 2013 issue of Going for Growth take a value of one if “significant” action is taken and zero if not. See in OECD (2015) for more details.

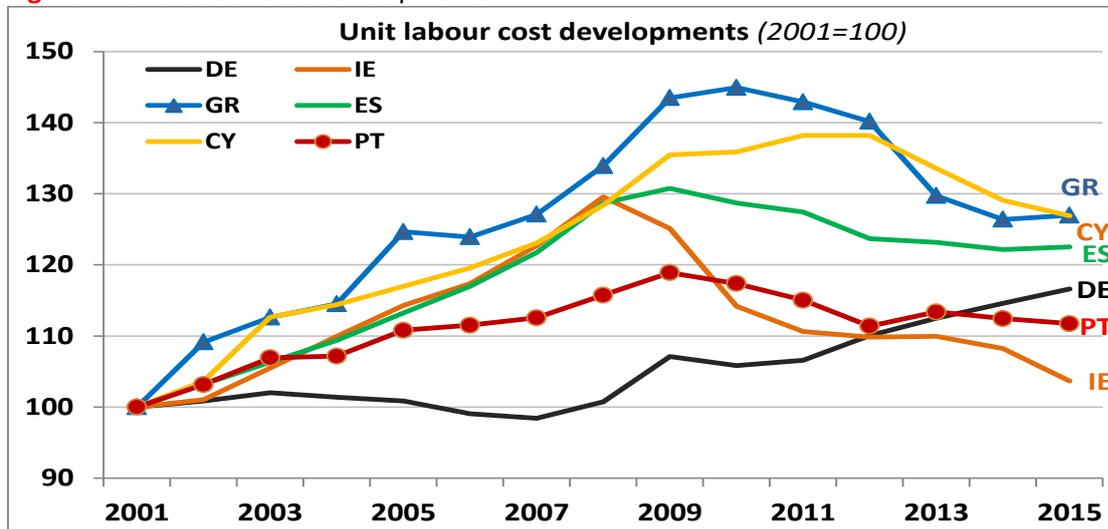
Despite considerable pain, the busy reform record produced few positive outcomes: GDP is still contracting and unemployment hovers around 25%, prices remain more or less unchanged, while exports are *stagnant*. A vicious austerity circle was in operation: two thirds of the improvement were due to revenue increases. Arrears to the private sector were used as a buffer for consecutive program reviews. To add to these, debt overhang continues to poison expectations.

Between the impressive policy inputs and disappointing economic outcomes lurk the hidden and possibly unaddressed **structural problems**. Dealing with fiscal and current account imbalances, though clearly necessary, proved not sufficient for a turnaround in the Greek economy.

The external balance serves as an illustration. Competitiveness, in addition to structural reforms *should have* benefited from lower labour costs (Figure 4), from looser labour protection legislation and greater ease of doing business, where Greece’s ranking in the World Bank indicator rose from 110 to 60 (Arkolakis et al, 2017; Lyberaki et al, 2017 forth). Yet, in contrast to other program

countries, that effort came to nought. Figure 5 shows that all of the external improvement achieved was due to import restraint explainable by the fall in incomes. In contrast, exports in 2014 were lower in volume terms than in 2008. So far from repeating (say) Latvia’s or Ireland’s experience of export-led recovery, the Balance of Payments remains a constraint to larger growth as before. The key question remains ‘Why do exports remain stagnant?’ or ‘Why cannot competitiveness rebound?’.

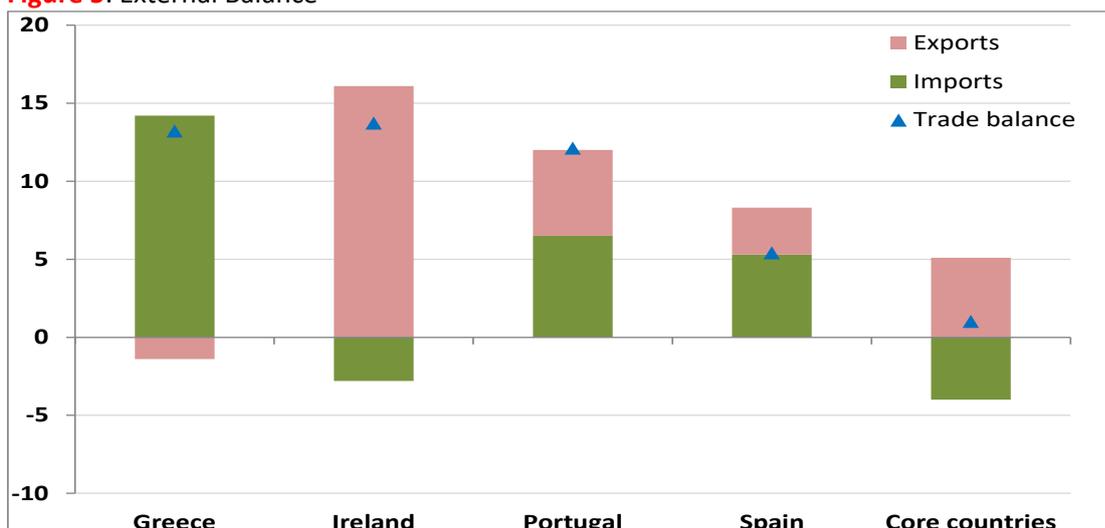
Figure 4: Unit labour cost developments



Source: Eurostat, Labour productivity and unit labour cost.

Some efforts to explain the behaviour of Greek exports, offer conjunctural explanations, such as the rising cost of energy⁶ (Mitsopoulos, 2014; Pelagidis & Mitsopoulos, 2014), or a combination of taxes, rigidities in the product sector and high trade costs (Petroulakis, 2016; Arkolakis et al, 2007 forth). Though a valuable addition to public discourse, conjunctural explanations actually make the explanation *more* difficult. Once the negative impact is reversed, there should be a rebound—possibly at a quicker pace in order to catch up – which has not happened. The persistence of problems of competitiveness is due to a deeper malaise.

Figure 5: External Balance



Source: Based on Galenianos (2014) calculations.

The *specific* conundrum for exports can be generalised. This macro overview can be summed up as reforms coming up against an overwhelming lack of response - an ‘irresistible force meeting an

⁶ Tax hikes and electricity price increases by the state-owned Public Electricity Corporation has led to an effective increase in energy costs by 60% for producers (Mitsopoulos, 2014).

immoveable object'. This lack of response is itself a factor in continued austerity. Why is it that, while macro-economic indicators improve, the real economy is not responding? Why aren't incentives working? Could aggregate analysis be missing a key ingredient and in this way locking in austerity?

2.3 The missing agent? Small firms in Greece

The macroeconomic narrative, by dealing with aggregates, obscures the question of agency. To see *why* there is no response, we must turn to *who* is not responding. This means examining the crisis from the viewpoint of those making decisions that is from the viewpoint of firms. Is there something in the structure of production and the characteristics of firms that explains their lack of adaptation? Is the lack of adaptation a characteristic of *all* firms or are there distinct groups?

In our view, most analyses ignore the identity of the agent who is making decisions. This agent, in Greece, is the small family business -the ubiquitous form of business organisation. Greece's economy is dominated by smaller-sized firms, together with very high self-employment (36% of all civilian employment vs 17% in EU27).

This type of business organisation is very common in some emerging economies and in developing countries and is not unique even within the EU. What is a "Greek eccentricity" is the combination of very small firms with very few larger firms. In the non-financial business economy (Mylonas & Tzakou-Lambropoulou, 2016) Greece has:

- The lowest average size of firms in terms of people employed (3.1 versus 6.4 in EU27)
- The lowest proportion of employment in large firms (> 250 people): 13% versus 33% in EU27
- The third lowest proportion of value added produced in large firms (27% vs 42% in EU27).

Within manufacturing as a whole, Greek micro firms (employing up to 9 people, including the owner) account for 46% of employment and 32% of value added (14% and 7% respectively in EU27). In the crisis years, more than 2/3 of employment losses in the private sector (730.000 jobs) were due to the closure of about 220.000 small firms (30% of the existing small enterprise count). Furthermore, small and micro-enterprises suffered greater declines in sales, while they were also more vulnerable to capital controls compared to larger firms (ibid).

The prevalence of small firms is not unique to Greece. It has always been the case that the world of small business is very heterogeneous, displaying various business characteristics, and widely differing business prospects. The prevailing characteristics are familiar from the development economics literature: an unclear division between the family and the firm, state regulations applied only selectively, widespread tax evasion frequently tolerated. Nevertheless, within the universe of small businesses, some firms are outward looking, technologically advanced and agents of innovation. In other words they displayed the main ingredients of dynamic competitive firms. The potential of small firms was underlined in the 1980's by Piore and Sabel (1984). This led to a kind of 'Small Scale Industry Renaissance' in the development economics literature stressing the potential for dynamism of small firms, provided they are embedded in a broader production grouping.

This Renaissance never arrived in Greece. Greek economics remained wedded to the kind of Orthodoxy that held small firms in universal disdain. The dominance of small firms is treated as an irregularity of Greek production, a remnant from previous epochs, which must make way for modern large firms. The Left in Greece reveres and still reads early-progressive industrial strategy, such as Batsis' monumental 1947 work *Heavy Industry in Greece* (Batsis 2004); this generalised Soviet input-output theory to argue for strengthening backward linkages⁷. Even contemporary liberal accounts of

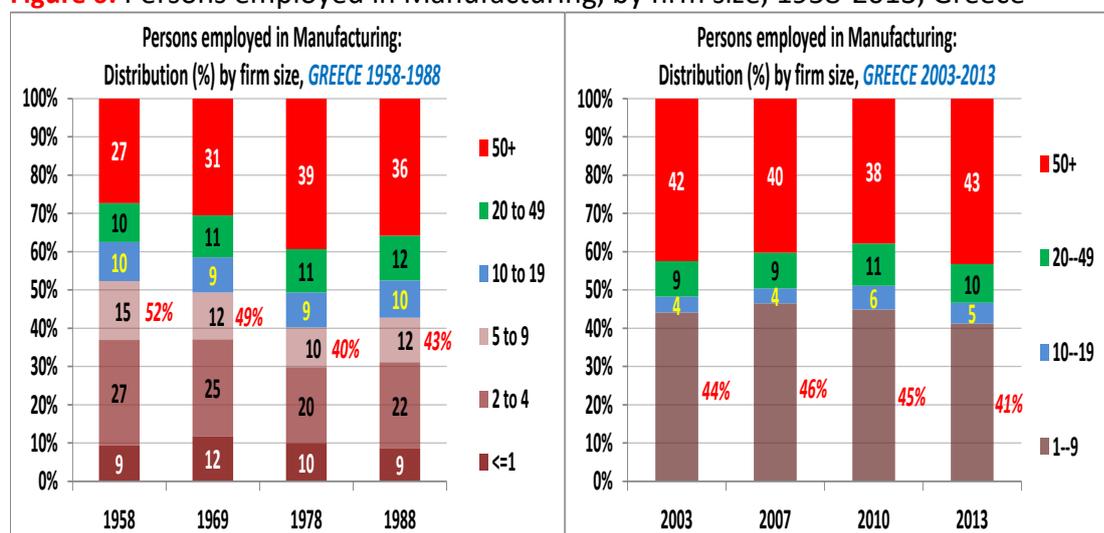
⁷ cf Lenin's attacks on the Narodniks in the *Development of Capitalism in Russia* (Lenin 2004, published 1899), can be found in Batsis' work. Batsis is an important part of ideological baggage for SYRIZA.

the crisis (Doxiadis, 2013; Arkolakis et al, 2017) treat large firm as the only possible vector of modernisation. The large firm’s technological advantage is stressed by, for example, Caloghirou et al 2004, while more recently there is emphasis on large firms’ desirable fiscal characteristics (Tatsos 2001, Pryce 2012). In political terms Batsis’ fascination with the large firm is overtly or tacitly encountered in all party manifestos since the end of the dictatorship (1974) in Greece – tempered of course with protection of the small entrepreneur/voter. The implicit belief in this premise is widespread, that often arguments are no more than blanket dismissals: ‘successful countries have large firms, hence large firms are necessary for success’.

It is little wonder, then, that the demise of the small firm has been confidently (and repeatedly) predicted. This happened after EC entry in 1981 and again when the euro was adopted in 2001 (GDI, 1980). It was seen as axiomatic that in a climate more open to competition and to the forces of globalisation it would be only large firms were fit to survive; small firms would go under. In actual fact the *opposite turned out*. Small firms, survived their ‘imminent demise’, and even prospered. Both their share of production and employment grew after each warning. Conversely, larger firms had greater difficulty to navigate the globalised world, leading to waves of ‘ailing companies’. Especially in sectors of low and medium technology, smaller firms proved capable of increasing employment faster than large firms (Agiomyrgiannakis, et al, 2006; Lyberaki and Mouriki, 1996).

Figure 6 gives a summary picture of the crucial role of small firms in the Greek manufacturing structure since the mid-20th century. It shows that their share remained more or less constantly more than 50% of manufacturing employment throughout. In terms of the number of firms, their presence was even more impressive: Firms employing up to 9 persons constitute 94.8% of manufacturing in 1958, 93.9% in 1978 and 94.7% in 2002 (ELSTAT, various years). The small firm ecosystem survived the transition to EU membership, and navigated the Euro-Zone era up to the crisis - due to firms’ resilience and capacity to adapt.

Figure 6: Persons employed in Manufacturing, by firm size, 1958-2013, Greece



Source: For 1958 to 1988 data obtained from Census of industry, crafts and commerce enterprises, 1958; 1269; 1978; 1988, Hellenic Statistical Authority. For years 2003 to 2013 data obtained from Structural business statistics, Eurostat. In the latter series, there is a break (2003-07) & 2008-2013.

In sharp contrast, things are different in *this* crisis. Small firms are failing in large numbers; this failure is not counterbalanced, by waves of new firms. The extensive destruction of small family firms has a crippling effect on the domestic productive system. The volume of sales declines more in smaller than in larger firms in every crisis year. Supplies of raw materials, cross-border services and collection of receivables create severe problems primarily for smaller firms after the capital

controls⁸, just as cash resources are drying up (Mylonas and Tzakou-Lambropoulou, 2016). Furthermore, extensive business failure is accompanied by an ‘exit’ trend, as more and more small businesses are trying to relocate abroad or even start-up a new firm elsewhere in the EU.

The plight of smaller firms could supply the ‘missing link’ we are seeking: the economy is not adjusting owing to developments in the small firm sector - which sharply distinguish this period of crisis. This time round, what enabled a rebound of the economy previously was no longer operative. The question is *what* and *how*?

An optimistic reading is that ‘we still are in the middle of the road’ and adjustment is sure to come eventually. The theory of the ‘compressed spring’ – sooner or later there is bound to be a rebound - is useful as intellectual indolence to avoid uncomfortable questions. However, it sounds increasingly desperate – especially when it is avoiding evidence accumulating.

The conceptual framework proposed in the next section accounts both for the build up of Greece’s problems in 2010, as well as for the difficulties to overcome them. It does so by supplying the missing link: the interaction between productive structure and the macroeconomy, which is generated through the operation of small firms in the Greek political economy. It thus provides more than the truism that adjustment would have been better had Greek firms been larger.

3. A conceptual framework placing SMEs at centre stage

To explain the observed pattern of resilience and subsequent distress of small firms, and in order to track how that developed over time, we need a conceptual framework which assigns a role to small firms, while focusing on how macro-economic imperatives of competitiveness and fiscal balance impinged on production. This conceptual framework is composed of three elements:

1. A micro-structural explanation dividing production into large firms and two categories of small firms – dynamic and defensive.
2. A macro sustainability explanation focussing on how the competitiveness gap and the public sector deficit were addressed – a generalisation of the ‘Dutch disease hypotheses’
3. Putting the two elements together: how do the macro imperatives impact on the productive structure? How do those reactions affect the macro-economy *back*?

This conceptual framework is then put to work to explain the observed developments in both production and macroeconomic equilibria from the growth of the 1960s to the bailouts and impasse of the 2010s.

3.1 The micro account –two types of firms

Throughout the post-WW2 period, the world of small business in Greece hosted a variety of different firm dynamics. In the interest of clarity and simplicity, the two ideal types of firms can be called ‘dynamic’ and ‘defensive’. The big picture of performance encapsulates the constantly shifting balance between these two types of small firms (see Lyberaki, 1988, 2006 and 2011; also Papadogonas and Droukopoulos 2004, Droukopoulos and Thomadakis, 1993,1994; Papadogonas and Voulgaris, 2005).

Small family firms everywhere share a number of common features: The most important is responsiveness and capability to adapt to changing environment, born of short decision structure and non-bureaucratic organisation. Similarly, small business often assigns a key role to the family. This plays a central role in financing the start-up, in supporting expansion and accumulation and frequently in supplying flexible (and often unpaid) labour. The fluid boundaries between the family and the firm can strengthen the resilience of both firm and family; on occasion though they may lead

⁸ Capital controls were imposed prior to the referendum in June 2015 and remain in force.

to a self-reinforcing downward spiral. For example the absence of limited liability means that there is easy circulation of factors of production between the family and the firm, or indeed between different activities run by the same family.

In short, the small family firm often uses its flexibility to bypass barriers that can block larger firms or to economise on scarce resources. Their small size can lead to relative ease in bypassing the regulatory framework (below the radar of inspections), which can be important in many contexts. Similarly, where (formal) sector finance is in short supply, they can use family owned real estate both as a store of value but also as collateral for finance. This fungibility was exploited as a source of strength. However, it can also operate negatively. In the current crisis, and as tax collection is improving, the growing liabilities of families for property tax are becoming burdens for businesses, which were previously immune. The lack of limited liability may yet prove the Achilles' heel of small firms in the crisis.

These characteristics early on in Greek economic history crystallised in a dual structure of small firms – most evident in the case of manufacturing: The distinguishing criterion is their attitude to risk and preparedness to compete: *Defensive* firms seek to hide behind protection, while *Dynamic* firms are ready to compete on a domestic or international scale.

Defensive firms are risk averse and utilize their flexibility (and their lack of visibility) to muddle through to their survival. They thrive in an environment where there exists a large element of discretion. They thus lobby for protection in product markets but also for regulations that may hamper their rivals. Their numbers and extensive personal and political networks are used to widen the field of political and other discretion as correctives to the operation of the markets. Their prosperity is thus dependent on the possibility of drawing economic rents from controlled access to factors of production (finance, regulation) secured through political influence; they thus form the backbone of the 'clientelistic networks' on which Greek political economy was based from the start (Doxiadis 2010). Low quality of production meant that, once markets became more open, costs were kept low through extensive use of family (chiefly female) labour or unregulated migrant labour when that started being available in large numbers after borders came down in Eastern Europe. Defensive firms thus come close to the stereotypical derogative representation of small firms as a relic from the past. Their owners, and their employees form an electorally important coalition and provide the backbone of opposition to most types of structural reform (Doxiadis, 2013).

Defensive firms, their owners and employees, are key players in Greek political economy. They demand protection, but give little tax revenue in return. As a result, their demands from the State are correspondingly modest. They encourage a low-quality public expenditure equilibrium with few expectations from public services, both in services to enterprises but also in the form of social safety nets for employees. This frees public expenditure to be used to bolster the size of public employment as an end in itself.

Dynamic firms, on the other hand, are those who use their flexibility to compete and seek new markets at home and abroad. They thus 'play the game' of competition and can function under a rules-based or market-based system of discipline. Being innovators they are often open to networking and cooperation. Such successful small firms are not uncommon worldwide and have been the object of study internationally: They have been studied under the rubric of Flexible Specialisation (Piore and Sabel, 1984), industrial clusters (Schmitz & Nadvi, 1999), and networks forming Global Value Chains (Gereffi, 1999). Stress is laid on how clusters of small firms connect to global markets through intermediary traders or global buyers (Schmitz & Knorrington, 2000; Schmitz, 2004). These approaches analyse ways in which small firms may use ingenuity or adaptability to overcome possible obstacles of small size to carve a resilient niche for themselves in a globalised market. They also examine the ways in which public support and business services can help overcome some of the disadvantages of small scale. Especial emphasis is laid on the fact that recent technology advances are scale-neutral and in some cases even beneficial for small firms. Small firms

can thus be important vectors of innovation and technological advancement – both as start-ups and in modernising existing businesses even in traditional sectors.

Such ideal-type of firms exist in Greece in all sectors of production: They exist in tourism, and to a lesser extent in agriculture -which in the pre-crisis period was in the process of transiting from peasant subsistence to capitalist production. However, they have been studied chiefly in manufacturing (Lyberaki 1988, 1998)⁹. Their preferred competitive tool is quality-related rather than price-dependent. They are, thus, more responsive to demand changes in the international and European markets, and have been successful in locating niches of opportunities. It is noteworthy that the opening of borders in Eastern Europe was seen as a business opportunity -not only as markets to export, but primarily as buying-out existing factories and creating mini-value chains with export orientation (Lyberaki, 2011).

Dynamic enterprises had always to ‘swim against the tide’ in Greece. Competitiveness among small and medium enterprises, across the world, benefits from agglomeration and types of cooperation and collective action, such as marketing consortia. Successful collective action cannot occur in a vacuum; instead, it requires mechanisms of institutional support and socially embedded norms of trust (Humphrey & Schmitz, 2002). It is precisely those institutional and norms-related requirements, which are thin on the ground in Greece. Institutional support never overcame narrow individualism, while ‘inherited trust’ dwarfed ‘earned trust’ (Lyberaki and Paraskevopoulos, 2002). Lacking effective institutional and shared values support, dynamic small firms had to follow lonelier, yet highly diversified strategies. Their varied responses and refusal to ‘take the easy option’ of securing preference through political pressure determined the split between ‘dynamic’ and ‘defensive’ segments of the industrial structure¹⁰. The variety of responses also conditions SMEs’ competition for scarce resources (labour, capital, influence).

In what follows, we examine how that equilibrium between dynamic and defensive small firms operated over time, and what has changed during the crisis.

3.2 The macro account: Dutch disease economics

The dynamics of the Greek macroeconomy are characterised by the interplay between the need to finance external payments – the balance of payments deficit – on the one hand, and the necessity to finance the State – the public sector deficit – on the other. *Both* are intertwined with the production structure.

The Public sector deficit arises from the juxtaposition of a chronically challenged revenue base and the needs to spend, which are determined chiefly by the scope of the role of the State. The dominance of firms of the defensive variant makes collecting taxes more difficult, while a clientelistic State dictates the size and destination of public expenditure (selective cash transfers rather than quality service provision). For example, the reluctance to widen the revenue base in order to capture small scale enterprises or the resistance in real estate taxation were both linked to pressures from the majority of small producers. Similarly, there was little pressure for quality in public services (such as education), or for flexicurity (social safety net, training, unemployment benefits) as this was peripheral to defensive business priorities. This left the State free to concentrate on long term income transfers (pensions) or expanding public employment.

The chronic external deficits were the result of a *competitiveness* deficit. Production structures from the start were such that a relatively narrow foreign exchange earning sector of tradables had to provide for a majority engaged in non-tradable activities. The conditions of production of tradables

⁹ Manufacturing should, in any case, benefit from backward and forward linkages with both tourism and agriculture. The relative paucity of such linkages is part of the problem to be answered.

¹⁰ When a small firm gains in importance it may decide to ‘go the way of large firms’ and attempt to negotiate protection for itself – rather than persisting with what may be a losing battle.

were always crucial for overall competitiveness. The key mechanism in operation since the second war may be understood as a generalization of the 'Dutch disease' argument.

A '**Dutch disease**' occurs when inflows of foreign currency lead to currency appreciation and hurt competitiveness, leading to deindustrialisation. A more general approach disengages from exchange rates and refers to cases where success in one area/sector, leads to inflows of funds and in this way ends up reducing incentives to compete. The Netherlands gave its name to the phenomenon when a boom in natural gas exports led to the appreciation of the real exchange rate. The ensuing de-industrialisation was estimated to be more rapid than the "normal" process of relative industrial employment decline that happens when countries reach a certain level of per capita income (Palma, 2014). The term Dutch Disease is used to include countries (both industrialised and developing) that exhibit a "specific additional degree of de-industrialisation"(ibid: 16).

So, besides the original meaning of the Dutch disease – that is, the macro-economic chain reaction following the abrupt appreciation of the real exchange rate (Corden & Neary, 1982; Ros, 2000), the concept was expanded. Palma (2005, 2014) argues that the Dutch Disease can also occur for reasons such as strong financial-services exports (as in the UK, Switzerland, Luxembourg and Hong Kong) or more broadly booming service-exporting sectors such as tourism. In the latter case he cites Greece together with Cyprus and Malta. Similarly, other inflows of capital, such as surges from remittances from workers living and working abroad, as happened in the South of Europe in the 1950s and 1960s, could operate in the same fashion.

This analysis can be used to provide a driver for interpreting macroeconomic developments. Already in the mid- 1980s, John Spraos, had formulated a version of the Dutch Disease *a la Grecque*. He used it to explain what he saw as the paradox of the Greek economy, namely rapid economic growth without an expansion in manufacturing. *"This coincidence of a relatively high level of economic development, and of a low level of industrialisation is explained by a peculiarity: three large sources of foreign exchange – tourism, shipping and remittances – which cover, between them, 40% of all imports... and, in so doing, maintain a high value of the drachma. This makes Greek manufactures uncompetitive."* (Spraos, 1984).

Since that time, many factors accentuated this Greek version of the Dutch Disease. Full accession into the European Communities (with the phasing out of all transitory periods by the 1990s), generated an increasing flow of funds into the Greek economy. Eurozone entry led to a vastly increased supply and reduced cost of foreign borrowing. The plan for entering the Eurozone clearly envisaged using the ensuing credit boom to aid competitiveness – 'the high road of growth' (Papademos 2001). In the event the country chose 'the low road', of bankrolling short-lived prosperity, eventually leading to the long (and winding) crisis-tunnel. So, credit was used to boost public sector consumption, thus adding a further twist to the Dutch disease. The choice of the easy road over the more difficult alternative is not incidental. Dysfunctional Greek political economy results from the interplay of macroeconomic constraints with an idiosyncratic production structure. It is to this interplay that we now turn.

3.4 A transition mechanism – from macro to micro.

Much in Greek political economy is due to the mingling of a dual SME structure with the twin macroeconomic constraints. This, for a long time, resulted in rising GDP, with only modest growth in manufacturing. The exports to imports ratio increased up till EU accession; after its maximum of 55% in 1981, it fell continuously to 30% in 2008. The gap in the current account was financed by inflows of funds: initially via the «invisibles account» (emigrants' remittances, shipping and tourism), later due to EU transfers and in the EZ era by easy credit.

Inflows were used to prop up the uncompetitive majority of defensive firms, and not to strengthen dynamic firms. The more inward-looking SMEs easily outnumbered the rest, and consistently had the upper hand in political economy. In the 'clientelistic system' uncompetitive firms exploited their

political leverage to secure privileged access to resources. Bank lending was a case in point: Access to credit was heavily influenced by local politics, while lending depended on the existence of collateral, chiefly of real estate¹¹. More generally, the Greek economy was characterised by political discretion over the operation of impersonal rules, such as those arising from market discipline. The multitude of overlapping regulations were akin to an overdetermined system of equations; contradictory requirements mean that motion is possible only through intervention of political fiat. This intervention came from the executive, either to repay favours or to create obligations.

The balance between dynamic and defensive firms lay behind the competitiveness problem. The probability of success of the two types of firms depended on the State, as the actor exercising discretion; it issued licenses and labour regulations, determined non-wage labour costs as well as access to borrowing. Political influence pulled towards defensive firms¹². Competition, in the form of EU pressures and globalisation strengthened the case for competitive enterprises. This delicate balance was further influenced by fiscal developments. The need to shore up the uncompetitive majority increased public expenditure and created the need for public funds; these were acquired either through public borrowing or by increasing taxation. To the extent that the defensive majority were politically influential, this meant retention of the narrow tax base¹³ and a rising burden for dynamic enterprises. Finance for expenditure and pensions, both necessary for networks of clients, had to come from borrowing – even with low quality or non-existing business services.

4. Putting the framework to work: 1960s-2009

4.1 A general overview

Between the early 1960s and 2009, Greece was transformed from a successful developing country to the Eurozone's problem-child (Figure 7). In terms of GDP per capita, up to the 1970s Greece was outperforming the OECD; this was followed by stagnation in the 1980s. Good performance resumes in the mid-1990s for growth rates to collapse after 2008. Greece, despite its relatively small size, is not markedly open. Even after five years of reforms, trade openness in 2014 is well below the average for the OECD. In the same period trade openness only increased in a few discrete episodes – largely coinciding with the GDP periodisation.

Can a *single* explanation explain all periods? As was shown in section 2, most accounts of the crisis begin from the late 1990s and focus on the last period, when Greece was struggling as the last and least well qualified member of the Eurozone, missing the earlier periods of success. Examining the two macroeconomic constraints together with the dual SME production structure can move us in the direction of a single narrative. In that narrative the Dutch disease essentially operates by altering the balance between defensive and dynamic small enterprises. This operates to depress the rate of growth but also to stoke up public finance problems for the future.

¹¹ The way loans were decided and the possibility of appropriation of business loan for personal enrichment was behind the creation of 'ailing industries' which meant the demise of larger firms in the 1980s.

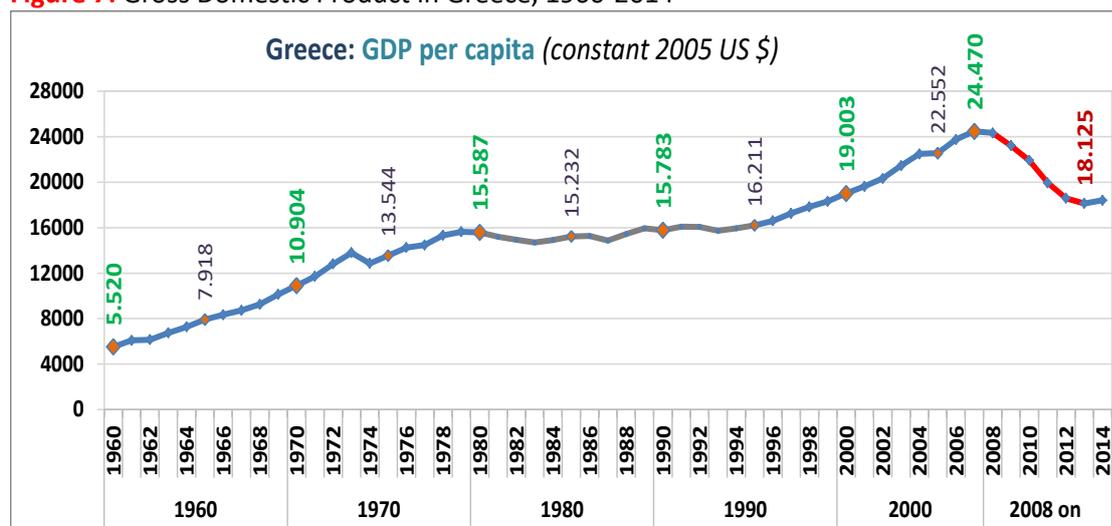
¹² The operation of social insurance with heavy reliance on minimum pensions operated as a subsidy to firms operating in the 'grey economy'. Tinios 2013.

¹³ Even in 2017, after 11 tax reforms since 2010, 55% of households are exempt from tax due to the high threshold.

Table 1: A Periodisation of the Greek Economy and the role of SMEs

Period	External conditions	Dynamic SMEs	Defensive SMEs	Non Small Companies	State and Fiscal
1960s and 1970s	Widespread protectionism and fixed exchange rates. Exports increased to their maximum (55% of Imports). Balance of payments financed by Remittances, Shipping and Tourism (invisibles) Dutch Disease	International subcontractors (played by rules of world market). Exporters	Domestic market orientation, subcontractors of larger Greek firms (for the domestic market). Non exporters	Easy life, sheltered from international competition. «Live and let others live too» (Alexander 1962) Privileged relationship with State (protection, procurement and access to banking system)	Rigid regulation, particularistic favouritism to big domestic firms, facilitation of access to credit and banking system. Small state Balance in public sector account. Debt small and manageable
1980s and 1990s	EU member but long protective transition till late '90s (backloaded). Exports declined as % of Imports (40%). Shipping and tourism, together with EU funds: new version of Dutch Disease	Former subcontractors graduated and acquired own brand. Still exporters. After the late 1980s they also relocated (partly) and participated in mini-value chains.	Same as before. State procurement policies created a market for inward looking firms. Main adjustment strategies: cost-cutting and shifting from production to imports and trade of same products.	State procurement, prolongation of protective barriers. Also, first generation of «Ailing Companies» which shifted the burden fully to the state and the tax-payers	Radical expansion of the state sector Rise in public expenditure financed by borrowing, leading to inflation. Structural funds provide finance for Balance of Payments and for fiscal affairs. Rapid increase of public expenditure. Tax system adapted to clientelistic priorities (narrow tax base).
EZ years	Openness to trade from EU. Pressures for liberalizing product and labour markets (unsuccessful). Exports declined further as % of Imports (30%). Latest version of Dutch Disease: easy credit at low cost.	Relocation trend continues as well as the formation of mini-chains in Eastern Europe and Balkans. Relocation in lieu of exports increasingly the case	Spill-over from demand fuelled by increasing incomes and private indebtedness kept traditional defensive small firms going. Shift to imports substituting for production still strong. New customers: immigrants. No exports	Kept afloat on credit, faltering exports, mainly domestic market and diversification towards real estate and other services.	Further expansion of state financed by borrowing. Rapid consumption growth financed by borrowing allowed the economy to remain on a knife's edge (high borrowing-low interest rates)
Crisis years	Recession, wage cuts and fiscal rebalancing. Impressive Import restraint. Exports fall. The end of Dutch Disease leads to extensive destruction of firms.	Previous export champions in deep trouble. Extensive destruction and closures. Exit trend (for incumbents and start-ups) to EU.	Extensive destruction and struggle for survival. Political pressure to avoid foreclosure blocks the banks.	Attempts to relocate headquarters. Wave of bankruptcies of established large firms. Domino effect on their smaller suppliers.	Unsustainability exposed. Dramatic rebalancing. Tax hikes (personal, enterprise and VAT, social contributions (highest tax wedge on labour in EZ). Property taxes. Wage reduction largest in EU.

Figure 7: Gross Domestic Product in Greece, 1960-2014



Source: World Bank, World Development Indicators.

An explanation spanning the sixties to the present is outlined in Table 1. It examines *four* periods: The emerging economy on the verge of entering the family of advanced countries (1960s/ 1970s); the EU entrant (1980s 1990s) and major recipient of community funds; the Eurozone laggard (2000s); finally the serial bailout failure (2010s). The external drivers are set out in the first column: From the relative protection of the 1960s, to gradual opening after entry in the European Community, to greater opening (but plentiful finance) of the Eurozone. Developments after the bailout will be examined in greater detail in the following section. Three columns examine the situation for the three categories of firms: Dynamic SMEs, Defensive SME, and other non-small (large, often public) firms. The last column examines the role of the state in determining relations between firms and in creating the fiscal environment.

Dynamic enterprises were from the start oriented to exports. As European integration proceeded and international competition intensified they reacted by participating in value chains. As competitiveness challenges multiplied, they increasingly chose relocation rather than expanding export sales.

Defensive enterprises, on the contrary, had always focussed on the domestic market. Where they could not ring-fence their business (e.g. in manufacturing) they shifted from production to trade in the same lines, importing the products they used to manufacture. When the crisis blocked that road too, they tried to wait out the recession but as it lasted longer than expected they either tried to cease their operation altogether or to relocate abroad.

Most **large firms** from the start preferred the easy life of a privileged relationship with the State. Despite the hopes pinned on larger firms, most could not survive EC entry; some were brought in to public ownership as 'ailing enterprises', but folded or both ownership schemes. In the EZ years larger firms maintained their privileged status by being kept afloat on credit, often diversifying towards real estate to take advantage of the boom years.

The dichotomy between dynamic and defensive firms is not rigid; in most sectors we find both types of firms coexisting. There is some movement between the two categories. Some previously defensive firms responded actively to liberalisation by cultivating external markets. Some dynamic firms after a point succumbed to the charms of the easy life. However, the nature of protection was such that there was little *direct* competition between the two types of firms, in the sense of competing for the same orders. That left competition between them for access to scarce resources – skilled labour, loan capital. The next section looks at the garment sector in greater detail, in order to illustrate some of the general points made.

What explains the relative absence and the patchy record of large firms? The shipping sector, which was the locus of large fortunes, saw itself as part of the world economy with little attachments to its home base (other than a holiday destination). Large capitalists were often members of the Diaspora themselves, with active links out of the country – which many did not hesitate to rekindle after Greek ventures failed. Greek agriculture was always based on small cultivators whose rapid decline provided the labour force for urban industry in classic Lewis-style fashion up to the 1970s. Tourism grew quickly, but with the exception of a few large firms, quickly conformed to the dualist SME model. This left small-scale manufacturing as the central player.

The account of the faltering manufacturing sector in Greece can be presented as phases of a Dutch-Disease type of malaise. In the **pre accession (1981) era** the Greek economy financed trade deficits through income generated abroad (tourism, shipping and emigrants' remittances). This allowed the emergence of a sizeable state sector and a business environment hostile to competition. Small firms increased in numbers but had few incentives to risk foreign markets. Hence, the dynamic type of small firm remained a minority in the productive structure. Their strategy was to become international subcontractors in what was then the New International Division of Labour (Froebel et al, 1980). At the time, wage costs in Greece were low compared to Germany and other European countries: large foreign producers in cost-sensitive lines (such as garments) relocated part of their labour-intensive production in low-wage areas in Southern Europe. In the **1980s and EMU years**, the 'big story' of non-production-enhancing capital inflows continued, though their *composition* changed. Remittances were more than made up by tourism and inflows from the EU (corresponding to 2.5 to 3.5 percent of GDP annually). Small firms survived in spite of rising wage costs; they were protected in the opaque area beyond the scope of the tax authorities. In the **EZ years**, this was supplemented by cheap state borrowing from the private market *after* EMU entry (2001). Government debt rose sharply, as did debt held by foreign entities. The result was a prosperity bubble unrelated to productive potential, productivity or exports. Wages caught up with wage levels of European partners, and the cost-effectiveness evaporated. A countervailing force to rising production costs was immigration from Eastern Europe post 1992; the arrival of hard-working immigrants (approximately 12% of the labour force) increased the supply of labour and injected some flexibility in the rigid labour market.

So, when Greece joined the euro-system in 2000, its sector of internationally traded goods and services corresponded to 25% of GDP –the lowest in the EU15 at the time. This low share of tradables coincided with poor productivity, while both the trade and the current account were in the red. This weakness worsened in the EZ years. So, in 2009, tradables were just 20.5% of GDP. To make matters worse, the composition of tradables deteriorated¹⁴.

All in all, that period was not conducive to productive upgrading and to extrovert business strategies. A retreat from manufacturing was only to be expected, as many firms ceased production to become importers of the same goods. Others sought an easy life by relying on public procurement and/or ensuring that their markets remained closed to competition. On the other side, the small dynamic fringe of family businesses, expanded in the Balkans and Eastern Europe and formed mini-value chains along the lines of 'triangular manufacturing' (Lyberaki, 2011). But these constituted a minority group with little tendency to grow in number. Trade openness and exposure to international competition remained low among Greek firms. Greece in 2014 rated low among other OECD countries of comparable size in terms of trade openness.

¹⁴ Ioannou and Ioannou 2013 divide tradables into "Baumol goods" where endogenous improvements in quality are key, and "Dutch Disease goods" whose prices do not depend on technology advances. They conclude that the decline in tradables was *not* due to the cyclical movement of the world economy: the share of the "Dutch Disease Goods" remained constant at 9% of GDP between 2000 and 2009). What did shrink was their "Baumol goods", from 16% in 2000 to 11.5% of GDP in 2009. All other European "small open economies" have a considerably higher share of Baumol goods in their GDP (ibid).

The support of this system required borrowing. Endemic fiscal deficits meant that the economy from the 1990s was on a knife-edge: Debt was only serviceable due to the fortuitous coexistence of low interest rates with relatively high GDP growth. When the Credit Crunch increased interest rates sharply in 2007, keeping GDP high by borrowing was blocked. The crisis became inevitable. (Hardouvelis 2011).

As the above narrative makes clear, it was not only public finances which were proven insupportable, but an entire constellation of political economy practices. Prominent amongst the latter was the effort to maintain the universe of enterprises of low growth potential but of high political value. This happened at the expense of the parts of the economy that could have increased the potential for growth and could finance the external and fiscal deficits.

4.2 The case of the Garment sector

Up *till the mid-1980s*, garments producers formed the backbone of the Greek manufacturing in terms of number of firms, employment share, production and, more importantly, exports. Protectionism and export-promotion schemes, combined with low wage costs had attracted a number of clothing contractors to Greece, who found capable and relatively cheap subcontractors among the domestic clothing firms. Exports increased, partly facilitated by fixed exchange rates. Domestic firms of all sizes thrived and expanded. They sourced mainly domestically from the strong local textiles sector, which was made up of large domestic firms).

The first serious competitive pressures materialized after the mid-1980s and were largely linked to the gradual abolition of protection and the phasing out of export promotion schemes. **Throughout the 1980s and the 1990s** there have also been continuous increases in wages; these transformed Greece from a low-wage to intermediate wage economy. These eroded the traditional cost-based competitiveness of Greek garments. Imports increased markedly, while exports were on the decline. In this period, garment contractors of the previous period moved out of Greece, seeking lower-wage economies to relocate to. A lot of domestic firms had to close down, while the index of both clothing and textiles production between 1985 and 2000 halved. High interest rates and accumulated debts led to the first wave of failing and 'ailing' companies which, after protracted efforts to remain in business, finally closed down.

It is in this era of heightened competitive pressures that one can discern the different responses of defensive and dynamic garment producers. Large domestic firms (both in textile and garments) stumbled, while some of the oldest closed down. Some relied on smaller domestic manufacturing suppliers, which had been hit hard from the loss of their clients. Others were suppliers themselves (of textiles) to Greek garment producers; the latter had to source from abroad or –when they could not afford it because of their small size- had to buy imported textiles from the domestic market. The defensive small firms attempted to cut production costs via cheaper labour (and, hence, hired newly arrived immigrants from the Balkans). As imports were becoming cheaper and exports less attractive (as export subsidies declined and then ceased altogether), many defensive firms stopped producing altogether in order to become importers of the same products. *Dynamic* firms (some of which were the anonymous subcontractors of the previous era) opted for an altogether different strategy: they placed emphasis on quality and design (and less on price) as a means of developing their own brand. They tried to take advantage of the new markets in the Balkans and Eastern Europe not primarily as consumers, but as co-producers; They relocated part of their production in neighbouring Balkan and nearby Eastern European countries, they entered joint-ventures, they formed networks of subcontractors and occasionally bought whole factories in the transition period. They remained committed to exports throughout.

The **Eurozone years** saw further decline in domestic garment production, as manifested by the smaller number of firms and the smaller number of employees. Imports continued to increase (by 10% during the first 5-year period) in the fully liberalized European Economic Area, while exports

continued their faltering trend (exports declined by 13%, against only 3.5% in total manufacturing exports). The overall economic performance of the Greek firms deteriorated markedly after 2000 (Lyberaki, 2011); Domestic producers were strained not only from competition but also from steep increases in unit labour costs in combination with the appreciating euro. It has been estimated that during the first 5 years of EZ membership, Greek manufacturing suffered a 20% loss of competitiveness (Alpha Bank, 2005: 33). Apart from international competition, domestic and well established large firms were very hit hard by the Athens stock-exchange turbulence of 2000, which interrupted and cancelled all planned investment projects for modernizing production (Giannitsis et al, 2001). Defensive small firms either moved out of production altogether, or concentrated further in lowering their costs. In general, with increasing incomes, the prospect of trading imported garments was seen to be attractive. Dynamic firms chose a different path: they intensified their international orientation, tried to produce more and more of their production abroad (in lower wage areas), and some of them moved up the value chain by abandoning direct production and becoming «new intermediaries» (Lyberaki, 2011).

5. The Crisis and the small firm: Villain, victim or potential saviour?

We have argued that, although small firms exhibited resilience and capacity to adjust, their survival is being questioned by the crisis *for the first time*. There are at least *five* reasons to explain why small firms were *especially* hit by *this* crisis.

First, lack of access to credit and liquidity problems were more severe for small firms: in a recent SMEs survey carried out by the Bank of Greece, the majority of small firms reported limited access to credit as their most pressing problem (ECB, 2013; Mylonas & Tzakou-Lambropoulou, 2016). To make matters worse, Greece was one of the few countries where leverage (indebtedness) as well as interest payments as a proportion of turnover were increasing (Arkolakis et al, forth). These developments took place against a background of plunging sales and profits; hence, internally generated liquid assets at the disposal of firms became virtually extinct.¹⁵ The overall shortage of capital was felt more keenly by dynamic firms, which had to compete internationally. The defensive firms were well versed for a hand-to-mouth existence, and were the first to benefit from the repeated debt holidays. Capital controls after 2015 dealt a coup de grace in many cases, especially to export businesses.

Second, the State makes more insistent demands on firms via tax hikes, special levies and more thorough tax collection. The crisis years saw an over-activity in tax regulations (dozens of tax laws and hundreds of ministerial decrees were enacted). Confusion prevails as to the exact obligations and their future.¹⁶ Special levies made things worse and added to confusion, while the intensification of efforts to collect tax revenues has brought to the fore smaller businesses who were effectively operating under tacit state tolerance. Indirect tax rises (mainly VAT in various instalments) took a further toll on SMEs (Petroulakis, 2016). Probably the single most problematic tax from the point of view of smaller firms was the property tax. This hurt small firms' Achilles' heel – their lack of separation between the family and firm. The fact that the state makes higher demands throughout the crisis is testified by the sharp increase of tax revenues as a percentage of GDP (in 2016 amounted to 50% of GDP, while in 2007 in was less than 37%). Thus the tacit low taxes/low quality agreement with defensive small firms -'We collect few taxes but you get few services'- was broken. Austerity meant that business services were early victims while their stunted growth was postponed further.

¹⁵ Postdated cheques were the preferred mode of finance for trade credit and day-to-day transactions. These during the crisis disappeared.

¹⁶ As Arkolakis et al remark "Neither businesspeople, nor their accountants, not even tax officials are sure of what is in force" (:25)

The state's strained finances also led it to sharply increase arrears to contractors in crucial areas such as health care, predominantly small firms. Arrears were also created by large firms passing costs on to their smaller suppliers.¹⁷ The State also systematically delayed returns of VAT and other payments to exporters to economise cash.

More importantly, this transfer from the economy to the state does not find its way back to the economy; it is used up to cater for state financial needs and obligations, such as public payroll, pensions and debt servicing. Public investment was the area hardest hit by austerity.

Third, SMEs did not benefit from wage cuts. There are reasons why lower nominal wages were never especially important for SMEs: their reliance on unpaid family labour and on undocumented workers meant that they already had access to cheap work. Dynamic firms' competitive edge was dulled. Reforms towards flexible labour markets, which should have benefited them, had in practice very little impact. They came late, were often contradictory and implementation was problematic. Labour market reform is still on the to do list in 2017 (Lyberaki et al 2017)

Fourth, the business environment deteriorated. Family businesses trying to catch up with extrovert strategies need a supportive *business environment*, including the ease of doing business and a supportive infrastructure which offers opportunities to access new markets, suppliers, techniques and partners. That environment became more difficult for smaller firms to navigate. The impact on dynamic small firms was more devastating. Grexit fears from 2010 and capital controls from 2015 did much to destroy networks of international cooperation. This was added to pre-existing issues – such as the weakness of the logistics sector (prime example being distribution networks by road)¹⁸ constitutes a significant barrier to trade and exports. Lack of openness in road haulage meant considerable disadvantage for small firms¹⁹.

The broader business environment deteriorated for three reasons.

- A. Apart from the obvious macroeconomic impacts, access to finance and tax regulations, prolonged uncertainty and low expectations further eroded trust and cooperation for extrovert business initiatives. Networks of cooperation (both domestic and global) are more important in crisis, as an answer to the problems of fragmented industrial structures to address vulnerabilities due to 'loneliness'. However, participation in them was discouraged due to uncertainty, Grexit fears and capital controls.
- B. Policy instability became for the first time a problem for SMEs. The crisis increased their visibility – necessitating compliance with the regulatory framework. In the past, unanticipated policy changes and contradictory regulatory requirements used to be a problem mainly for larger firms. Now even small firms entered the radar of the authorities, encouraged by the presence of the troika. Penalties for non-compliance increased dramatically, while the cost of full compliance (including the highest tax wedge in the EU) became unrealistic for a rising number of smaller firms with declining revenues²⁰ (Arkolakis et al p.26). More recently this trend was further reinforced: full compliance means that if

¹⁷ For example, the bankruptcy of a large supermarket chains in 2016 meant that suppliers with accumulated arrears will shoulder the brunt of an attempted rescue.

¹⁸ Transportation through trucks makes up 98% of land transport and is very inefficient and fragmented. 90% of operators work for own account, because the system is single-permit based, leading to 1.27 million companies/permits in a country of 11 million inhabitants. This is complemented with a very underdeveloped rail network and very restrictive licensing systems (World Bank, 2013).

¹⁹ Trade costs in general (including both logistics/transportation and state bureaucracy/customs processing system) can be seen as 'tariff-equivalent costs'. They exceed by far those of other peripheral economies; 22% higher trading cost with Germany compared with Portugal, 35% compared with Ireland, 55% compared to Spain and 72% compared to Italy.

²⁰ In 2013, verified tax debt increased by 4% of GDP. Over 40% of business-owners and self-employed persons found themselves in a situation where they had arrears on their own personal social security payments (Arkolakis et al: 26).

one takes into account the withholding of social security contributions, taxes and advance billing for next year's taxes, can lead on occasion to demands for tax exceeding 80% of the small firm's annual revenues.

- C. Even after years of reforms, the Greek economy compared to other EU economies is still subject to more frictions (restrictions on free trade) and remains less open. In other words, the environment still favours defensive over dynamic firms. In such an economy, prices do not fall and the decrease in aggregate demand caused by wage cuts translated into a contraction of aggregate activity and unemployment. Instead of prices reductions boosting competitiveness and exports, wage reductions increased profit margins and strengthened the shadow economy (24% of GDP in Greece vs 15% in EU27 in 2012).

Fifth, exit strategies of individuals and firms. An alarming side-effect of the prolonged crisis is to strengthen the tendencies to sever links – of giving up. This is a version of Buchanan and Tullock's 'Exit, Voice and Strategy'. There was a marked increase in the number of firms 'giving up on Greece' by choosing Exit over Voice. The top-down introduction of reforms led to widespread discouragement and deteriorated already low trust. Exit for small firms takes various forms:

- Exit of high educated young people and highly skilled professionals' emigration to Europe in search of better prospects. According to Lambrianidis and Pratsinakis 2016 approximately 650.000 young and highly skilled professionals emigrated since 2010. In contrast to the exodus of the 1950s, where a flow of capital back to Greece was generated, this exodus is accompanied by capital and entrepreneurship *leaving*.
- Producers in the category of 'intermediate players' (who had earlier relocated part of their production in Balkan and Eastern European countries) have been exiting their least productive activities and closing down most of their operations in Greece. As a result, for the first time they ceased to try to rescue the domestic component of the company, and instead shifted all efforts towards strengthening their operations abroad).
- There was an exodus of firms out of Greece. In some cases firms relocated to Cyprus or Bulgaria, for tax reasons. Anecdotal evidence indicates that the flow is accelerating, especially after the social security changes to contributions. Greek tax accountants report that a number between 70.000 and 80.000 firms have already applied to relocate abroad (Liberal.gr 2016).
- New dynamic start-ups in the crisis years are few, but tend to be even more outward looking. Successful firms *either* chose their location in Europe (full exit), or opted for «dual geography» solutions (in part exit), whereby management and marketing are based in London, Boston, New York or California, while some operational and technical processes are still carried out in Greece, to take advantage of lower costs and ample talent.

To recap, in the past, a large part of SMEs survived and prospered due to fluid boundaries between firm and family finances; the latter dried up quickly during the crisis due to higher taxation obligations and due to the sharp increase in unemployment. Real estate has historically been the main asset both of firms and for families, used both as store of value and collateral for loans. Real estate has been hit especially hard by new taxes on property (and more efficient enforcement).

Looking ahead, it is worth posing the question of the potential role of smaller firms in the recovery of the Greek economy. Must the recovery *necessarily* imply fewer small firms? How plausible is it to continue to perceive small size as obstacle to prosperity and growth?

Even during the crisis there have been some encouraging examples of successful dynamic small firms. Skordili 2016 examines cases from the agro-food business, which combine innovation, high quality, niche marketing and local branding. These cases were successful during the crisis even though consumption fell and the market share of large producers grew. Another example can be sought in high-end Greek Fashion in clothing, shoes and bags (branded as Grecian chic), using traditional artisanal materials but with a modern edge. Finally, some innovators have appeared in

tourism rebundling the tourism product in new ways. The Greek firm Taxi hailing start up TAXIBEAT, was founded in 2011 and bought by Daimler for \$43 million in 2017.

Nevertheless, orthodoxy in Greece, including in SYRIZA circles, holds that the recovery can be expected from large firms only, while the potential contribution of smaller firms is missed out or ignored. However, this view ignores key aspects of the Greek record by building on widespread anachronistic myths about the potential of small firms. It is fully possible that, as in the past, the dynamism of small firms could be harnessed by overcoming deficiencies in the productive structure which stand in their way.

Such a scenario could come to pass if concerted effort is expended to address upgrading production and encouraging exports. The latter cannot be feasible without intensive networking and immersion of firms of any size into global value chains. Recovery *could be* based on small business, provided a new type of industrial policy for growth is devised and implemented. To put the case more strongly, the only realistic *internal* scenario of recovery necessarily cannot happen without small firms. Any scenario without small firms must rely on external intervention – on the existence of a Deus Ex Machina to emerge at the right time.

6. Overcoming the production crisis: A conclusion

This paper has argued that persistent macro-economic disequilibria in Greece are not solely due to the Eurozone environment *nor* to Greece's Euro membership. The ineffectiveness of macroeconomic fixes is partly due to the crisis being perceived as exclusively "fiscal" in nature, in this way missing the underlying production and competitiveness crisis. Misdiagnosing it as exclusively macroeconomic and ignoring the structural dimension, could (and did) exacerbate the real issues. If reducing public deficit can just as well be attained through tax increases than through containing expenditure, that runs the risk of harming productive companies. If domestic routes of response are blocked by over-taxation, this can lead to the only credible route to recovery being through external injections of funds. The resolution of the crisis will have to wait for EU funds, debt relief, or for foreign investment. Whilst that '*Deus ex machina*'²¹ is being awaited, the economy languishes in recession. In this way perplexity about '*why are things not working as they should*' is transformed into fatalistic waiting for outside saviours. For those who do not want to wait, such an attitude may tip the scales towards 'exit' rather than 'voice' – leading to an exodus of both human and material capital.

The fatalistic view implicitly sees small firm size as a key problem to be overcome. In this view, small firms account for low competitiveness, lack of response to reforms, inability to increase exports and an unsustainably low tax capacity. If recovery is to come, that can only be through the large firms; perhaps more strongly, nothing much can be expected from small firms. Given that almost all large Greek firms are in bad shape, recovery must come from the outside.

In this paper we have argued for a different approach. *First*, our argument has been that the depth and the length of the crisis are due to underlying production vulnerabilities. These were nurtured for a long time through a mechanism whereby GDP growth was disconnected from manufacturing production and exports, a variant of the Dutch disease. This systematically discriminated against dynamic small firms of the kind that have been successful in the past and in other parts of the world. This motivated our *second* premise, that manufacturing competitiveness can be compatible with a

²¹ This does not question the simple truth that debt has to become viable. Debt overhang has to be settled, one way or the other with the provision of some **debt relief**. This makes good sense not only because debt overhang triggers very adverse expectations with strong impact on the economy, but also because at very high debt levels the incentive to reform is reduced (as most of the benefits from the reform will go to the creditors). Although debt relief alone would not solve the competitiveness problem, it could help if it is designed as an incentive to improve competitiveness via structural changes

large share of small firms in the productive structure. An important proviso is that such firms are extrovert, networked and innovative and can enjoy high-quality business services and social protection.

Whereas in previous crises, such dynamic firms were able to overcome difficulties, this crisis did not bypass smaller enterprises. After the initial shock, firm closures have accelerated and relocation strategies made matters worse. Whereas in the past it was the labour-intensive production processes that were being relocated, in the crisis years the firms moved their headquarters elsewhere in Europe, while start-ups (with Greek capital and operated by Greeks) found their way to Cyprus, London or elsewhere.

However, if our reading is correct, these developments are still reversible. Recovery *could still* be based on promoting competitiveness of the extrovert networked small firms. In other words, instead of expecting a solution via a *Deus ex Machina* (from above or from outside), Greeks could lay the road leading out of the crisis using their own resources and potential. This should involve a more business friendly and less unpredictable environment, less burdensome taxation and more incentives for firms to link-up with global value chains and increase exports.

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