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The Greek Fiscal Adjustment Programme: An evaluation

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The magnitude of the task facing Greece is now slowly being admitted by policy-makers. Following the European Council meeting of February of this year, the official mantra was that Greece had a plan to cut its deficit by 10% of GDP in three years and that by March it had already done enough for this year towards meeting this goal and that everything was under control. In the meantime, however, financial markets have been sending increasingly strident signals that they have little faith in the capacity of the Greek government to actually implement this adjustment as planned.

Even the most cursory glance at the official Hellenic Stability and Growth Programme[1] seems to justify the lack of faith on the part of financial markets.[2] The figures in the document (reproduced in the table in the annex) suggest that a substantial part of the projected revenue increases is unlikely to materialise (at least as quickly as planned) and that the hard choices and unavoidable cuts have been postponed. The key weakness of this budget is thus that it is not credible in the longer-run perspective, which is what is absolutely needed given that the required long-term adjustment is a reduction in the deficit worth over 10% of GDP. A reduction of this magnitude cannot realistically be achieved in a couple of years.

The Greek budget for 2010 contains measures that officially should produce an improvement in the deficit of 6% of GDP, with about two-thirds coming from revenue increases and one-third from cuts in expenditure, as shown in the table in the annex. A first comment is that successful adjustment programmes usually have the opposite distribution between expenditure cuts and revenue increases.

More in general, however, it seems that the potential for further revenue increases in the short run is limited.

Indirect taxes are the most important revenue for the government, but it will be difficult to increase revenues further in light of the fact that VAT has now reached 21% and excise taxes are already high. An important 'anti-fraud' law that was recently passed in the Greek Parliament is supposed to yield additional revenues worth about 1% of GDP. However, this is unlikely, at least concerning the revenue from personal income taxes, which lie at the centre of this law and which at present amount to only 4.7% of GDP in Greece. It is unlikely that the government can increase the yield from this source by 20% in one year (which is the

[1] See the website of the Greek Ministry of Finance (http://www.mnec.gr/en/economics/growth_programme_2005-8/Hellenic_SGP_Newsletter_April_2010.pdf).

[2] The upwards revision of the budget deficit for 2009 by close to 14% published by Eurostat on April 23rd, dealt a further blow to the credibility of the Greek fiscal accounts.

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increase needed in order to obtain the increase of 1% of GDP planned for 2010) when the economy is contracting at an accelerating pace. It is clear that the revenue from direct taxes could be increased considerably in the medium term, since on average this source amounts to 8% of GDP in the EU,[3] but this will take considerable time. The box below presents a more detailed assessment of selected individual measures contained in the Hellenic Stability and Growth Programme for 2010.

Review of individual measures taken in 2010 for Greece's Stability Programme

Revenue increases

The grand total of programmed revenue increases are projected to yield about 4% of GDP.

About one-half of this sum is based on increases in indirect taxes (VAT and excises). Most of this should actually materialise. However, some shortfall is likely as consumption is contracting, thus lowering the yield both on VAT and excise tax increases.

Moreover, about one-half of the tax increases is based on items that are unlikely to materialise because they take time to be implemented and have an impact on actual tax revenues. Let us consider the following four undertakings, which fall into this category:

1. *1% of GDP from measures to fight tax and social security evasion.* Every Greek government has promised to work on this front and this is unlikely to yield results still in the current year.
2. *0.5% of GDP from eliminating exemptions from personal income tax returns.* Most of this is likely to materialise from 2010 onwards (based on 2009 returns).
3. *0.6% of GDP from EU Structural Funds.* This is an accounting trick.* Structural Funds require co-financing. Speeding up of implementation would thus require more expenditure on infrastructure and would worsen the budget! Moreover, accelerating disbursement from the Structural Funds might have a liquidity effect, but this is once-off. There will be correspondingly less over the coming years.
4. *A one-off tax on 'profitable enterprises' worth 0.4% of GDP.* In reality, there might not be many 'profitable' enterprises left in Greece by next year.

Expenditure cuts

Here most of the items whose effectiveness is certain are the cuts in public sector wages (and benefits). Projected cuts in 'hospital costs' and 'operating costs' totalling 0.5% of GDP look doubtful.

* The new Greek government has promised a new era of budget transparency and there is no reason to doubt its sincerity. However, one might consider in this context the following quote from a 2008 Working Party of Senior Budget Officials on Budgeting in Greece: "The Greek programme budgeting pilot (2008 budget) is an excellent first step that clearly will be a great help in making the budget a more modern strategic policy document. In addition, it strengthens transparency in its clear overview presentation of the special accounts and the budget appropriations."

The key point is that one should look at the Greek budget as only the parting shot in the 3-5 year programme to achieve the goal of reducing the country's deficit by a total of 10% of GDP. Where are further improvements in the deficit to be found in an economy that is likely to severely shrink, and is thus unlikely to produce higher tax revenues?

The key issue will be on the expenditure side where all the cuts so far have been on the public sector wage bill. This is a convenient target, but in reality it does not constitute the main problem for the country. The public sector wage bill amounts to only about 11% of GDP in Greece (close to the EU average of 10%) and has not increased much in recent years.[4] With the 2010 measures, the wage bill will be cut to the EU average

[3] See http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2009/country/EL.pdf .

[4] See D. Gros, *Adjustment Difficulties in the Gipsy Club*, CEPS Working Document No. 326, March 2010.

and it is unlikely that the government will be able to squeeze much more from this sector. Cuts in the wage bill of state-owned enterprises would of course also be important, but they are not being discussed for the time being.

Significant cuts in social security benefits thus seem unavoidable. Social security expenditure accounts for about 30% of GDP and thus offers a base for cutting three times larger than the public sector wage bill. Moreover, most of the deficit that has emerged over the last decade can be attributed to the vast expansion of social security expenditure from a little above 20% of GDP to almost 30% of GDP. This is where deep cuts will have to be made if public finances are to be put on a sustainable basis in Greece. However, there is no sign that the government will be willing and able to push these cuts through before the crisis deepens.

Finally, the more detailed analysis of the individual measures taken under the Stability Programme suggests that one-half of the measures are not convincing and are unlikely to produce the planned effect, at least as quickly as planned. This applies in particular to the revenue side.

The joint IMF/EU mission, which has now begun its work in Athens, is thus likely to insist on substantial additional measures that need in any event to be initiated now if the country is to realise the goal of achieving a sustainable fiscal position by 2012.

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Annex

SGP Fiscal Measures Monitor

	Mln €	% GDP	Progress	
Revenue increases (+)				
Unique personal income taxation scale (elimination of exemptions)	1,100	0.5	Government decision and forthcoming legislation	
Higher property taxes	400	0.2	Government decision and forthcoming legislation	
Measures to fight tax and social contribution evasion	2,400	1.0	Government decision and forthcoming legislation	
Higher excise tax on cigarettes (in two phases)	850	0.4	Laws passed	✓
Higher excise on alcohol (in two phases)	160	0.1	Laws passed	✓
Higher tax on mobile telephony and petrol (carryover from 2009)	400	0.2	Law passed	✓
Fuel tax increase (in two phases)	1,280	0.5	Laws passed	✓
Excise tax in electricity and abolition of tax exemption	250	0.1	Law passed	✓
Introduction of excise taxes on luxury goods	100	0.04	Law passed	✓
Special levy on high-value real estate (one-off)	180	0.1	Law passed	✓
Special levy on profitable firms (one-off)	870	0.4	Law passed	✓
Revenue from bank assistance scheme (one-off)	280	0.1	Based on the provisions of the scheme	✓
Revenues from EU structural funds	1,400	0.6	Speeding up implementation	✓
Expenditure cuts (+)				
Public sector wage freeze	300	0.1	Law passed	✓
12% reduction in public sector wage allowances	780	0.3	Law passed	✓
60% reduction in the public sector 14th salary	610	0.3	Law passed	✓
7% wage cut and 60% reduction in the 14th salary in public sector enterprises	360	0.1	Law passed	✓
10% reduction in PPC and OTE pensions funds budget allocations	150	0.1	Law passed	✓
Public and private sector pensions freeze	450	0.2	Government decision and forthcoming legislation	✓
Reduction in short-term contracts	120	0.05	Law passed	✓
Reduction in overtime costs	75	0.03	Law passed	✓
Reduction in operating costs	360	0.2	Budget 2010	✓
Reduction in hospital costs	700	0.3	Budget 2010	✓
Reduction in the public investment programme	600	0.2	Government decision	✓
Reduction in education expenditures in the ordinary budget	100	0.04	Government decision	✓
Reduction in military expenditures	457	0.2	Delivery based	✓

Source: Hellenic Stability and Growth Programme Newsletter, 9 March 2010
(see http://www.mnec.gr/en/economics/growth_programme_2005-8/2010_03_08_Hellenic_SGP_Newsletter_No2.pdf).