COMMISSION
OF THE EUROPEAN
COMMUNITIES

Directorate-General
for Economic and Financial Affairs

Brussels, 23 July 1991
II/339/91-EN

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MACROECONOMIC POLICY AND STRUCTURAL REFORM IN GREECE

Performance and Prospects after Ten Years of Membership in the European Community

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Performance and Prospects after Ten Years of Membership in the European Community

I. Introduction

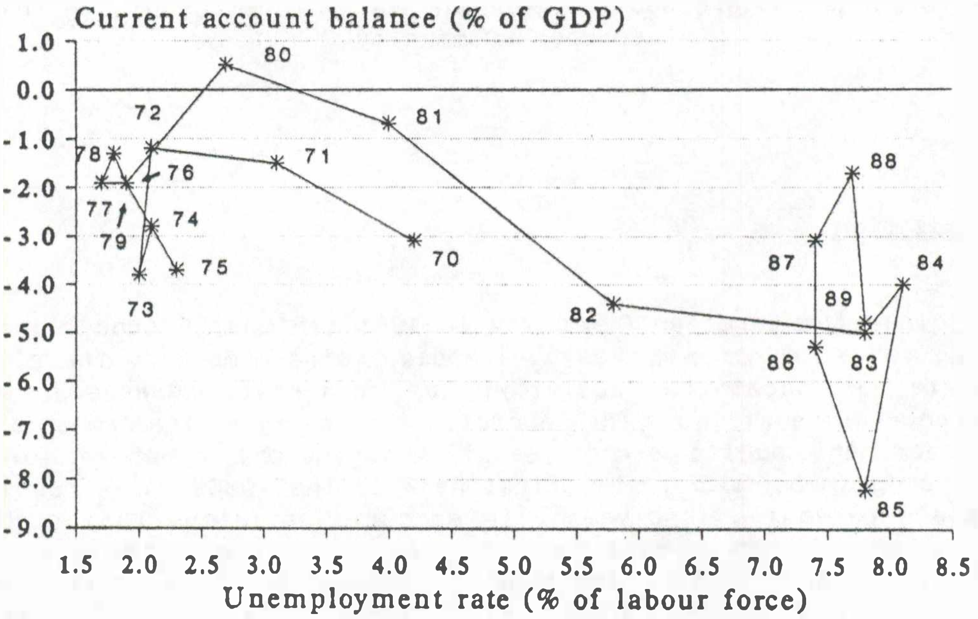
Greece joined the European Community in 1981. In most EC countries the following ten years were marked by a steady retrenchment in the role of the state in economic activity; by contrast, Greece's state interference intensified. The decision to enlarge the role of an already dominant public sector became a principal component of the economic program pursued in the first half of the 1980s. As a result of the state's pervasive involvement in economic decisions the economy's supply potential has diminished. At the same time, the increased demands on output made by the public sector, and the deteriorating productivity performance, have resulted in high trend inflation, financial instability, and severe fiscal imbalances.

A stylized characterization of Greece's macroeconomic performance in the past twenty years is presented in Graph 1. The locus of points of unemployment and of external deficits has shifted sharply to the right, implying that greater balance of payments deficits coexisted with greater unemployment in the 1980s compared to the previous decade. A similar message is conveyed in Graph 2, where the locus of unemployment and fiscal deficits since 1970 is presented. Expansionary fiscal policies in the 1980s have coexisted with a deterioration in external, labour market and output performance.

Greece's macroeconomic and structural difficulties became particularly apparent during the 1980s when membership in the Community has been characterized by a disappointing economic record. Greece had neither made any prior preparation to meet the Community challenges, nor did it undertake such steps once it became a member. Indeed, Greece's macroeconomic policies diverged notably from those pursued in the key Community countries during the decade, while the absence of structural reforms stood in marked contrast to the initiatives introduced in other member states. As a consequence, the process of catching-up to the rest

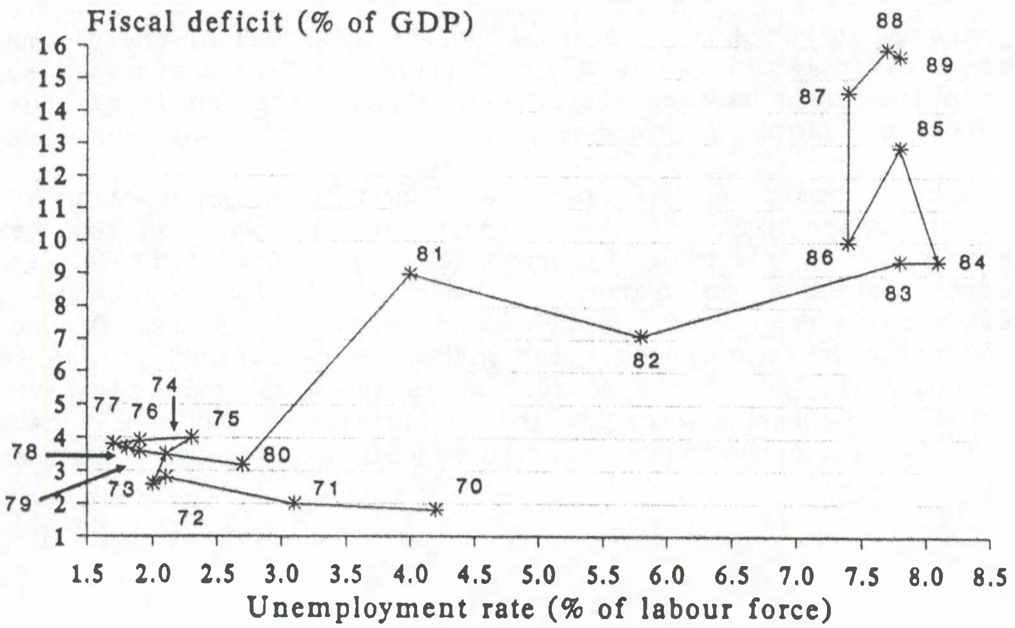
Graph 1

External deficit and unemployment



Graph 2

Fiscal deficit and unemployment



of the European Community has not simply ended; it has been reversed[1]. This raises serious questions about Greece's prospects for achieving nominal and real convergence with the Community, and about the policies which will be necessary in order to foster convergence.

In recent years there has emerged a range of indicators (a large underground economy, endemic inflation, persistent fiscal imbalances and rapid growth in public debt, rapid rise in external indebtedness, and the 1985-87 stabilization failure, to mention only the most prominent among them) suggesting that persistent domestic imbalances, if not addressed in a timely and irreversible manner, will permanently lower Greece's potential to achieve a sustainable improvement in the standards of living. In response to the emerging financial instabilities threatening a foreign exchange crisis, a three-year stabilization programme was formally initiated in the spring of 1991 in connection with a Community balance of payments loan. The broad aims of the programme are fiscal reform and structural renewal. Recent developments indicate that the implementation of the programme measures has encountered serious inefficiencies and delays. Furthermore, it has become clear that in order to remain within the programme objectives a greater stabilization effort will be required in the remainder of this year and in 1992. Since stabilization and adjustment could involve substantial economic costs which, in turn, could undermine the commitment to the policies, it is crucial that the structural reform initiatives are undertaken without delay, and that they complement the fiscal adjustment programme. Failure to take these steps could threaten the viability of the stabilization programme. To question the government's commitment to the programme objectives would invite a repetition of the 1985/87 stabilization experience which had disastrous consequences once the programme was abandoned.

Despite the similarities in the circumstances leading to the granting of a Community loan in favour of Greece in 1985 and in 1991, the latter episode has unfolded against a background of a different intellectual climate. The scope of Community objectives and targets has widened, offering new economic opportunities but also demanding new commitments. Failure to meet the requirements of the adjustment programme will not only increase Greece's divergence from the Community but will also severely diminish the prospects for raising the real incomes of its citizens over the medium-term.

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(1) Greece's per capita income in 1990 was 53.4% of the EC average; this compares unfavourably to the experience at the beginning of the decade when it represented 58.2% of the EC average. Ireland, Spain, and Portugal each have narrowed their divergence from the Community average during this period. See "Real Convergence in the Community", European Economy, Supplement A, no. 2/3, February-March 1991.

II. Macroeconomic Policy and Macroeconomic Imbalances

II.A The Fiscal Expansion of the 1980s

The thrust of fiscal policy became unsustainably expansionary in the 1980s. The share of central government expenditure in GDP rose from 26.6% in 1979 to around 43% in 1988; this share increased to over 48% in 1990 and is expected to peak at 50.7% in the current year. Factors underlying the growth of public expenditure have been the pronounced need to finance deficits of the social security organizations, as well as the shift of deficits from public sector entities to the government budget.

There has been a notable shift in the composition of public expenditure during the 1980s. The share of interest payments in GDP has advanced rapidly, from 2.7% in 1981 (8.8% of total public expenditure) to 11.6% (23.9% of public spending) in 1990; this is a reflection of the growing demands to service the accumulated debt. At the same time, the share of spending on consumption and transfers in GDP has risen by close to 10 percentage points in the period 1981-1990 (its share in total public spending, however, has declined by approximately 8 points), while spending in the investment budget has remained virtually flat at around 5% of GDP (but its share in total public spending has fallen from over 15% in 1981 to 9% in 1990).

Table 1
The Structure of Public Expenditure in Greece
(in percent)

	1980	1985	1989	1990
		% public spending		
Consumption and transfers	75.2	71.2	70.3	67.0
Interest payments	10.0	13.3	18.8	23.9
Capital spending	14.8	15.5	10.9	9.0
		% GDP		
Consumption and transfers	19.2	27.3	31.3	32.5
Interest payments	2.5	5.1	8.4	11.6
Capital spending	3.8	5.9	4.9	4.4
Total public spending	25.5	38.4	44.6	48.4

Source: Commission estimates

Tax policy provided only passive support to the increased spending. The share of central government revenues in GDP, which was 22% in 1979, rose by slightly more than four points, to 26.4% in 1988; in 1990 it was 28% and it is projected to be 34.8% in 1991. The behaviour of tax revenues in recent years reflects the decline in the effectiveness of the collection and assessment mechanism (widespread tax evasion, particularly in the administration of the TVA introduced in 1987), delays in the adjustment of administered oil product prices, failure to adjust in a timely fashion public utility prices, and tax exemptions granted.

Table 2
The Structure of Taxation in Greece
(in percent)

	1980	1985	1989	1990
		% revenues		
Direct taxes	18.3	16.4	17.6	18.9
Indirect taxes	44.3	44.6	48.1	49.8
Social security contributions	29.8	33.1	30.7	27.9
		% GDP		
Direct taxes	5.5	5.6	5.6	6.5
Indirect taxes	13.4	15.3	15.2	17.2
Social security contributions	9.0	11.3	9.7	9.6
Total revenues	30.2	34.2	31.5	34.5
Central government deficit	3.2	12.9	15.7	20.3

Source: Commission estimates

The principal consequence of the tax and expenditure developments has been the sharp increase in the government's borrowing requirements, both current and measured on a cyclically-adjusted basis. The central government deficit amounted to a mean value of 3.2% of GDP in the period 1970-79; in 1981 this ratio was 9.0% and peaked around 16% in 1988. Fiscal developments in the subsequent years have been particularly adverse. Central government net borrowing requirements were 17.6% of GDP in 1989 and were estimated to grow to over 21% of GDP in 1990 if corrective steps were not taken; the central government deficit (including amortization payments) rose from 3.2% of GDP in 1980 to a peak of 20.3% in 1990. In the event, the Greek government adopted a fiscal adjustment program to contain and reverse the deterioration in the public finances, and net borrowing requirements are estimated to have been 16.6% of GDP last year. Further progress is also expected to be achieved in 1991, when borrowing requirements are projected at 11.4% of GDP; estimates for 1993 place this ratio at 3.2% of GDP.

Fiscal developments in the 1980s, it may be argued, were motivated by an old-fashioned Keynesian approach to economic policy. In order to raise real income and employment growth, and also to encourage economic and social modernization, while, at the same time, attain income distribution objectives, an increasing share of economic and social responsibilities was transferred to the central government budget and to the wider public sector. However, achievement of these objectives became increasingly at odds with the maintainance of sound finances and with economic efficiency. The fiscal expansion together with the deterioration in the country's supply potential led to a significant increase in the inflationary pressures which had dominated Greece's economy after the oil shocks of the previous decade, undermining the country's public finances and macroeconomic stability. The fiscal expansion, on the other hand, has had little impact on the economy's growth performance, and a substantial crowding-out impact on investment spending. While predictable ex ante, the unsustainability of such policies became abundantly evident in 1985 and again in 1990 when conditions of an exchange crisis developed and Greece had to request balance of payments assistance from the Community.

II.B The Stabilization Crises of 1985 and 1990

The stabilization episodes divide the decade into two periods both of which ended with the adoption of adjustment measures to rectify the macroeconomic disequilibrium. The first stabilization measures, adopted in 1985, were abandoned in the fall of 1987; the second stabilization programme was initiated in 1990 and is currently implemented(2). The 1985/87 programme and its subsequent reversal, as well as the current difficulties, reveal clearly how onerous it is to implement adjustment in an economy where adjustment has been postponed for too long.

The fiscal course undertaken in the early 1980s was the principal factor behind the serious macroeconomic imbalances of 1985 when the current account deficit rose to almost 10% of GDP while inflation was accelerating and the drachma real exchange rate, measured on the basis of unit labour costs, had appreciated by 8.7% between 1980 and 1983.

The incipient balance of payments crisis necessitated the adoption of contractionary measures to restrain the rapidly deteriorating macroeconomic circumstances; the measures were undertaken in connection with a Community balance of payments loan amounting to ECU 1 750 million. Principal features of the 1985 programme were the containment of the external deficit, the deflation of domestic demand, and a restrictive incomes policy intended to promote adjustment; also, to offset the real appreciation which had taken place during the early part of the 1980s the drachma was discreetly devalued by 15% against the US dollar, while quantitative restrictions were also put into effect in an effort to contain the external deficit.

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(2) A review of the 1991 stabilization programme is presented in Annex I.

Table 3
Macroeconomic Developments 1984-1990
(percentage change and percent of GDP)

	1984	1985	1986	1987	1988	1989	1990
CPI inflation	16.9	17.7	20.7	15.2	12.6	12.9	18.6
Balance of payments	-6.3	-9.8	-4.5	-2.6	-1.8	-4.8	-5.4
Fiscal balance	-9.4	-12.9	-10.0	-14.6	-15.9	-15.7	-17.6
Real wage change	2.2	4.1	-7.9	-5.1	3.7	4.1	0.6
Domestic credit	20.5	22.1	17.6	13.0	15.5	20.0	16.0
Private sector	17.9	17.4	14.8	9.5	14.5	18.8	16.2
Public sector	21.0	24.0	18.5	14.8	15.5	20.1	16.5
Money supply (M3)	25.8	29.7	21.5	22.3	24.8	23.6	15.1
Drachma depreciation (+) against US dollar	24.7	20.3	1.3	-3.3	4.6	13.5	-2.4
Real depreciation (+), unit labour costs	2.3	1.8	15.3	3.5	-5.0	-4.1	-6.8
Real GDP growth	2.7	3.1	0.8	0.0	3.9	2.9	0.8
Nominal GDP growth	21.2	19.3	17.1	13.2	18.2	15.9	16.9

Source: IFS; EC Commission; Bank of Greece

As seen in Table 3, during the adjustment period there occurred a sharp decline in real wages, while the external deficit recovered to below 3% of GDP by 1987. Output growth was below 1% in 1986 and real output did not grow at all in 1987. Inflation also declined to a low of 12.6% in 1986 but, it is evident, that very little durable progress was made. The fiscal deficit changed by an amount which was not commensurate with the state of the macroeconomic imbalances. In addition, the fall in oil prices was not passed on to the consumers, thus imposing an implicit tax on imported fuels, and providing some of the much needed revenues.

The sustainability of the programme collapsed in the fall of 1987 and another fiscal expansion commenced. In the events leading to the second crisis, political difficulties and short-term expediencies dominated despite the sobering economic developments. It soon became apparent that the capital account would register a surplus significantly less than that required to finance the current account deficit at a stable exchange rate; in addition, depreciation expectations became particularly pronounced thus enlarging the external financing gap. Nominal growth accelerated reflecting the growth in liquidity, while output growth weakened. The recovery in real wage growth eroded the country's international competitiveness and by 1990 the real exchange rate had risen 17% above the low reached in 1987.

In these circumstances it became apparent that the external financing requirements could not be met without serious disruptions in the country's financial relations, and a balance of payments loan, conditional upon an adjustment programme, was negotiated with the Community. Unlike the earlier programme, however, the current one places major emphasis on both budgetary adjustment and structural reform in recognition of the fact that, unless the economy's productive potential is restored, the stabilization efforts will not be sustainable. The programme is defined in terms of fiscal and monetary targets to be achieved within a specified timetable. In addition, the programme measures have been set in such a manner that much of the adjustment is front-loaded to secure that the minimum adjustment required to halt the fiscal deterioration is securely achieved. Major reforms of Greece's social security system , of the wider public sector, and of the financial, labour, and goods markets are central elements of the structural component of the programme. The policy mix involves a restrictive fiscal policy supported by a non-accomodative monetary and exchange rate policy; unlike the 1985 programme, the current one does not involve a currency depreciation. Finally, while the public sector is subject to an income policy, wage determination in the private sector has been left to reflect labour market conditions. A further discussion of the programme is undertaken in part III.

II.C <u>The Impact of Fiscal Policy on Inflation, the Balance of Payments, and Growth</u>

Fiscal policy has been a decisive factor in Greece's extremely poor inflation performance. By contributing to rapid liquidity growth, fiscal policy has sustained the rapid growth of nominal spending, has undermined price expectations, and it has made depreciation expectations a recurring characteristic of the country's balance of payments flows.

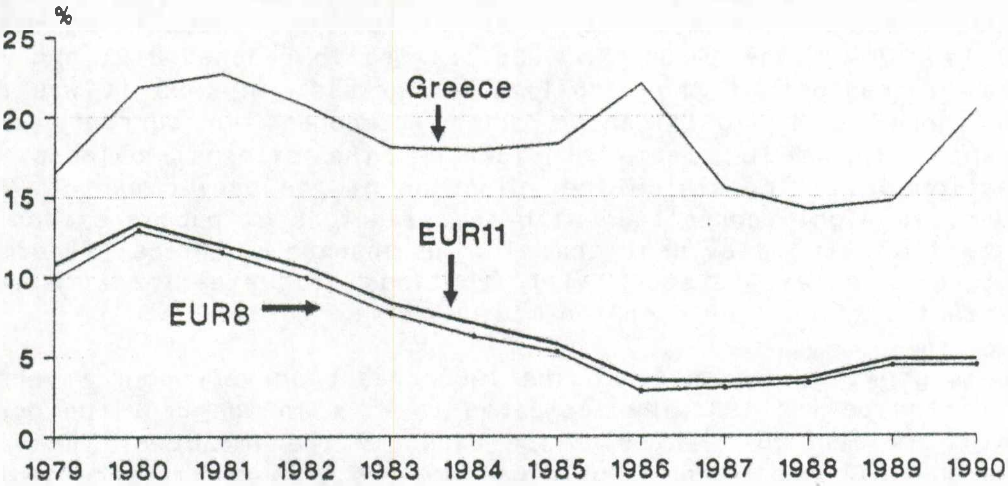
An important implication of the fiscal expansion of the 1980s has been the rapid growth in domestic liquidity. The share of credit to the government in total credit rose sharply, from an average of 26% in the 1970s to 56% in 1989; similarly the proportion of credit extended to the private sector has followed a downward trend and was 44% in 1989.

Credit extended to the government by the consolidated banking system has also advanced at rapid rates over the past two decades. However, unlike the 1970s when both credit to the private and to the public sector grew at parallel high rates (averaging 19.5% and 24.2%, respectively), in the 1980s the decline in the growth of private sector bank financing is partly a reflection of the increased demands for credit to accomodate the rising fiscal deficits. Over the period 1980-87 credit to the private sector grew at an average rate of 15.1%, and it had declined to 9.5% in 1987; credit to the government, on the other hand, advanced at an average rate of 26%.

Greece's inflation rose from marginally above the EC average in the 1970s to as much as three times the EC average in the following decade. This marked nominal divergence from Community inflation trends has been a notable feature of Greece's experience in the 1980s. The principal macroeconomic cause of Greece's high and stubborn inflation has been the failure to correct its persistent budgetary disequilibrium(3). The lax fiscal policy has undermined price stability and the credibility of anti-inflation policies pursued by the Bank of Greece. Econometric estimates suggest that Greece's inflation is determined by two principal factors: exchange depreciation and the excess supply of money originating in the budget deficit(4). Apart from this direct

Graph 3

Inflation in Greece and in Community countries



Source: Commission services
EUR8 = ERM excl. Spain
EUR11 = EUR12 excl. Greece

(3) Prior to 1973 Greece's CPI inflation averaged below 3%. Failure to adjust in response to the oil shock, and subsequent lack of steps taken to contain the rate of nominal expansion were compounded by the 1979 oil shock and by the fiscal expansion of the 1980s. During these years many Community countries implemented substantial adjustment programmes.

(4) The excess supply of money is approximated by the deviation of the demand for money (M1) evaluated on the basis of its economic determinants (the rate of interest, real income, and inflation) from the supply of money arising from the budget deficit; the latter is defined by the government budget constraint.

effect the fiscal imbalance contributes to the inflation process in an indirect manner through exchange depreciation; under quasi-fixed exchange rates a deficit-induced excess supply of money raises the balance of payments deficit, expected depreciation, and realized depreciation. In Greece's case, the coexistence of rapid monetary growth, persistent inflation, trend depreciation, and external imbalances are closely correlated with the fiscal disequilibrium.

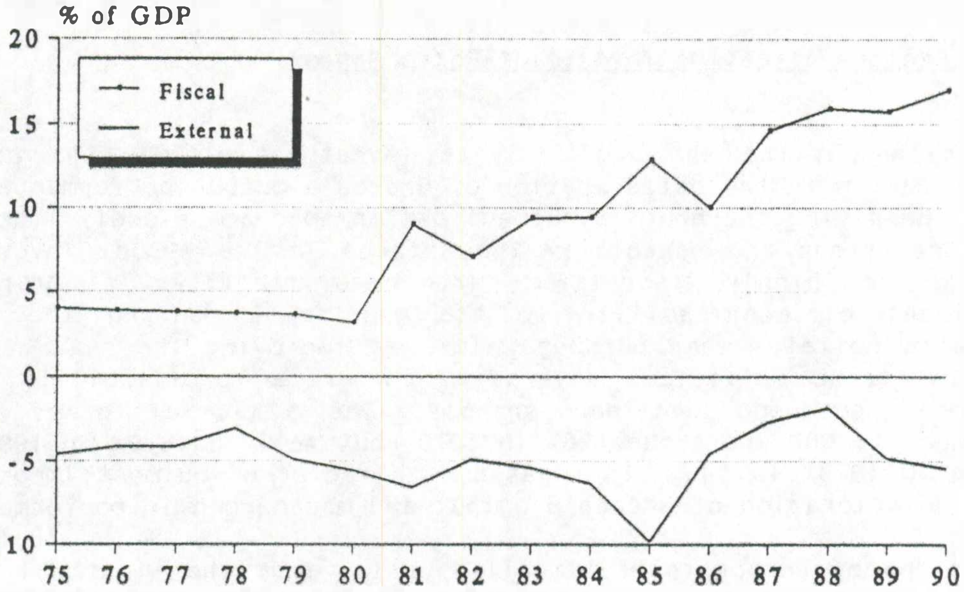
Greece has experienced serious balance of payments difficulties in the 1980s, and these have originated to some large extent in the expansionary fiscal policies pursued. Three principal macroeconomic factors have been at the background of Greece's external difficulties: first, the high domestic monetary growth, associated with the lax fiscal policy, has been partially converted into foreign money, goods, and services; secondly, the resulting inflation has lowered the demand for domestic money, thus contributing further to the incentive to exchange it for foreign money, goods, and services; thirdly, depreciation expectations induced by the fiscal disequilibrium have undermined net capital inflows putting severe pressure on the holdings of international reserves.

Greece's current account has invariably registered deficits throughout the past decade. The mean value of the current account deficit/GDP ratio is 3.7% in the 1980s. In 1985 this ratio reached 8.2% and was a central ingredient of the stabilization crisis; in 1990 it was 5.1%. While there is a significant cyclical component in current account movements, the medium-term behaviour of the external balance is a reflection of the persistent net disaving of the public sector. This, in turn, is highly correlated with the structure of public expenditure and taxation. It is evident that in the absence of fiscal reform and structural renewal Greece will continue to experience external adjustment difficulties over the medium term.

Greece's growth performance in the 1980s has been very poor, averaging 1.5% in the period 1981-1990 compared to 4.7% in the previous decade. While it is difficult to establish directly the impact of the fiscal expansion on Greece's real growth performance, the coexistence of large fiscal deficits with high inflation and low real growth constitutes the least propitious of economic circumstances. An expansionary fiscal policy and increased state interference may have inhibited economic growth by crowding out private investment, or by undermining the financial stability of the environment in which private enterprise can flourish; or by interfering with the incentive structure through greater government intervention; or, finally, by undermining rational resource allocation. In view of the fact that Greece faced very much the same external shocks as the other Community countries in the 1980s, the divergence in real growth performance is highly correlated with the intensification of state activity during this period.

Graph 4

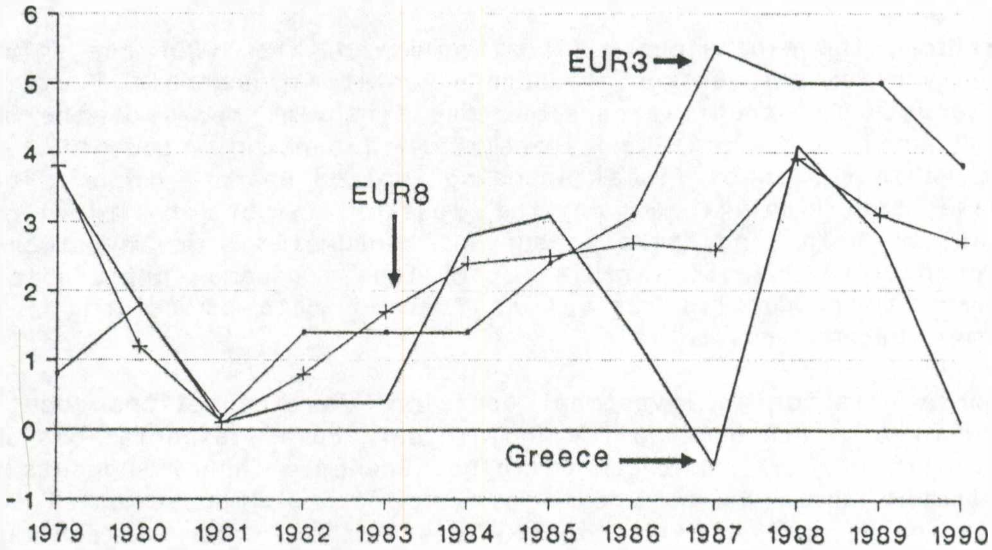
The fiscal and external deficit



Source: Commission services

Graph 5

Comparative real growth performance



Source: Commission services
EUR3 • IRL, P and E
EUR8 • ERM excl. E

III. The Supply Side

The decline in actual and potential output growth in the 1980s took place against a background of increased state intervention. This state activism contributed to affecting adversely the investment climate, labour market and competitiveness developments, price flexibility, and the performance of financial markets.

III.A Factors Affecting Investment Performance

The decline in the share of private investment in GDP has been a crucial factor in the deterioration of Greece's output performance. The causes underlying the poor investment performance are closely linked to policy decisions and especially those taken in the 1980s. Investment spending is highly correlated with profitability; a principal determinant of profitability is the wage bill. During the 1980s systematic policies were pursued, aimed at improving the real wage of workers; these affected adversely corporate profitability, and investment spending declined sharply. The ratio of gross fixed investment to GDP was around 26% in 1979, but fell to 16.9% in 1987 and recoved to 18.4% in 1990. This has been a factor of outmost importance in the deterioration of Greece's output and macroeconomic performance.

The decline of corporate profitability dates from the first oil shock (1973), but, in addition, labour market rigidities introduced in the 1980s have played a central role. Government regulations regarding layoffs, wage rates, and working time, have caused serious inflexibilities in firm behaviour and have been the principal factor in the sharp acceleration of labour costs. The consequent real exchange appreciation was not offset through nominal depreciation in its entirety and, as result, the rate of return in the traded goods sector fell substantially inhibiting investment activity.

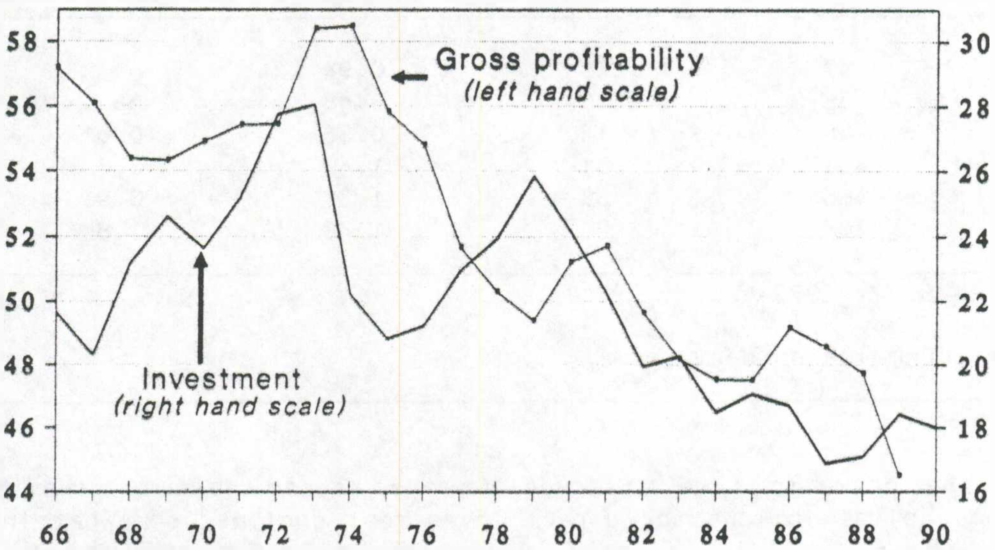
In addition, the expansionary fiscal policy of the 1980s has affected negatively private investment through a variety of channels. First, for given targets for credit expansion, the financial needs of the state have crowded out private investment financing; secondly, the unsustainable course of fiscal spending implied sharply higher future corporate tax liabilities, or the possibility of an inflationary outburst, or both; and thirdly, current consumption, or investment in less productive, less visible activities, became preferable to investment in productive capital as the net rate of return to this investment became less certain.

An important factor in investment decisions is expectations about the future course of economic policy and, in particular, expectations about the reversibility of announced policies. Economic theory suggests that a government which is not bound by constraints imposed outside its domain, such as constitutional restrictions or international commitments, has incentives to reverse its announced policies, once decisions are made on the basis of the initial announcements, at a later date(5). Once the private sector realizes this, the policy has no credibility and, in spite of announcements, the intended impact on the economy is not realized. Greece's economic policy has suffered from this distortion, and this has been reflected in, among others, private investment spending. Indeed, the reversal of the stabilization programme undermined the commitment to adjustment; the fiscal imbalances undermined the credibility of fiscal rectitude; the ad hoc administration of tax matters and the extensive use of regulatory measures adversely affected the incentive to invest. One example of policy inconsistency has been the extraordinary levy imposed in 1990 which retroactively taxed incomes earned in 1989.

Graph 6

Profitability* and investment

(% of GDP)



* gross operating surplus
Source: Commission services

(5) This is the problem of time inconsistency which underscores economic policies made without credible commitments that the policies will not change in the future.

For a country at a relatively low level of economic development and correspondingly scarce national savings, capital inflows from abroad are an essential factor in financing domestic investment. Furthermore, foreign capital in the form of direct investment is important for economic development because it incorporates technical progress and management know-how with significant positive externalities. Finally, the evolution of foreign direct investment is a good indicator for the attractiveness of a country to international investors, reflecting the general economic conditions prevailing in that particular country relative to alternative locations.

The data on foreign direct investment indicate that the attractiveness of Greece has declined in the 1980s, confirming the trends suggested by the behaviour of domestic private investment.

Table 4

Net Foreign Direct Investment in Greece

Period average	in USD million	in DRS billion at 1985 prices	% of GDP	% of gross direct investment inflow in the Community
61-65	47	20	0.94	na
66-70	38	13	0.48	na
71-75	50	12	0.33	0.6*
76-80	481	61	1.49	3.6
81-85	465	58	1.31	3.9
86-90	764	69	1.46	1.8**

* 1972-75; ** 1986-89

Source : Commission services

After the dramatic rise observed in the second half of the 1970s foreign capital inflows for direct investment declined somewhat in the early 1980s before rising again in the second half of the decade. It seems that the improvement in the investment conditions following the stabilisation programme of 1985/87 stimulated not only domestic investment but also capital spending from abroad.

This improvement, however, took place in a period of a substantial increase in the overall volume of foreign direct investment throughout the Community. The mean value of foreign direct inflows in the Community as a whole more than tripled in the period 1986-89 compared with the two preceding 5-year-period. Thus, despite the rise observed in absolute figures for Greece in the later part of the 1980s, Greece's share in total Community inflows declined sharply, as can be seen in

Table 4. On the contrary, the share of Portugal increased markedly while that of Spain fluctuated around 15% of the total in the 1980s.

Greece grants various investment incentives. Law 1262/82 provided for grants, subsidies, interest rate subsidies, tax favours, accelerated depreciation allowances, and other measures to encourage private investment. The disappointing investment performance of the past decade suggests that the tax expenditures provided have only contributed to increasing the budgetary costs. This law was replaced by Development Law 1892/90, which, among other provisions, gives greater weight to tax incentives, removes inequalities, encourages high-technology investments, and streamlines the various procedures.

III.B Labour Market Policies and Competitiveness

In Greece, the allocation of human resources is regulated to an important extent through state intervention, resulting in an inflexible labour market, low productivity, and high costs. For the most part of the 1980s, real wages have risen rapidly, while productivity has fallen. The government pursued policies aimed at raising the real wage bill of the workers, but economic stagnation militated against this objective. By fostering a climate of dependence and of unreasonable expectations for wages and employment, the policies have affected very adversely the supply side of the Greek economy. In addition, Greece's international competitiveness, which is a critical factor in the prosperity of a small open economy, was severely reduced. The reform programme aims at removing these distortions and enhancing labour market flexibility.

The chief features of labour market policies are inflexibilities in disemployment and layoffs, rigidities in wage determination, and rigidities in the allocation of working time(6).

Layoffs are governed by rules which require that the intended plant closure be approved by the Minister of Labour. Thus, it is possible that even bankrupt firms may be required to continue operating. In several instances the government was forced to take over unprofitable firms, and to continue paying the wages of workers. Many of these firms

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(6) According to survey evidence, Greece is considered by the business community to have the most rigid labour market structure. See "Employment Problems : Views of Businessmen and the Workforce", European Economy, no. 27, March 1986. Annex VI provides a review of labour market issues.

are now in the hands of the Industrial Reconstruction Organization (IRO), a body responsible for the management of problematic enterprises. Even here, however, it has not been entirely possible to discontinue employment despite the financial distress of the firms.

Greece's system of arbitration of wage disputes has reduced wage flexibility, and virtually eliminated wage differentials in the 1980s. An arbitration board, where the government representative dominates, is given the authority to set wages in an industrial dispute. In the event, the frequency of disputes taken to the board increased and the wages and salaries awarded were inconsistent with maintaining profitability. Consequently, many firms found themselves in serious financial distress.

Wage indexation was introduced in 1982, modified in 1985, and abolished at the beginning of 1991. Since the scheme provided for full indexation of wages of low-income groups, and partial compensation for others, wage differentials narrowed sharply; to this also contributed increases in the minimum wage. From the perspective of resource allocation, the policy-induced decline in wage and salary inequality could not have been optimal. It particularly undermined high wages and salaries and likely affected labour supply towards these professions. It is also questionable if the social objective of the policy was achieved. Indexation clearly narrowed wage and salary inequality, but could not reduce overall income or wealth inequality. Finally, it may also have contributed to the growth of the informal economy.

The length of the working week is strictly regulated, while part-time, overtime, and shift work are subject to a variety of binding restrictions. While some of these regulations are not perhaps observed in practice, they remain barriers to efficient labour allocation. For example, it is very difficult to find part-time work.

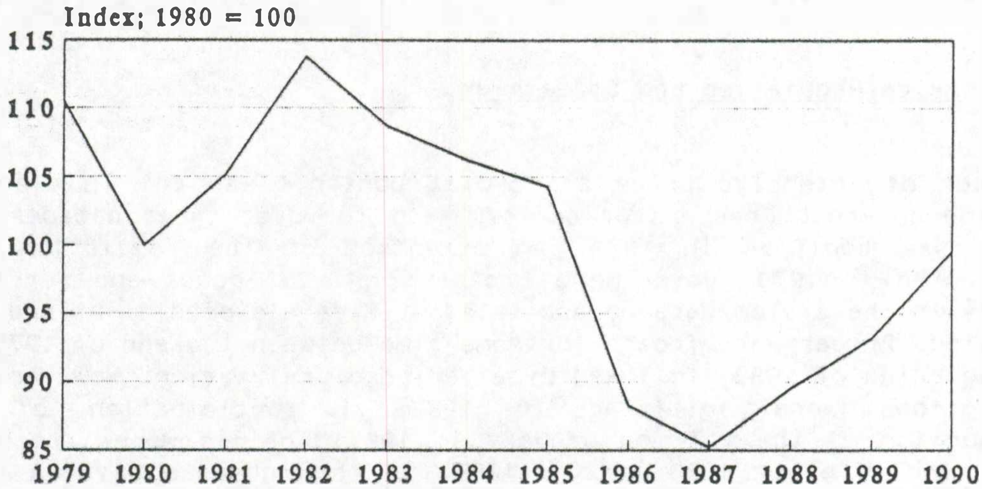
Finally, labour legislation adopted in the early 1980s on the regulation of strike activity, appeared to aim at minimizing the authority of unions in calling illegal work stopages. The legislation was opposed by unions and was ultimately removed in 1988(7). Consequently, the post-1988 regime governing strikes is more restrictive than the one it replaced.

An important consequence of the labour market program has been the decline in the country's international competitiveness. Greece's real exchange rate for the total economy, measured by unit labour cost relative to the EC 12 group, rose by 30.2% in the period 1980:Q1-1985:Q1; the real exchange rate for the manufacturing sector rose by

(7) The relevant legislation is Law 1264/82 and 1365/83; Act 1766/88 effectively repealed them. Additional legislation concerning arbitration was adopted in 1990.

Graph 7

Greece's international competitiveness total economy*

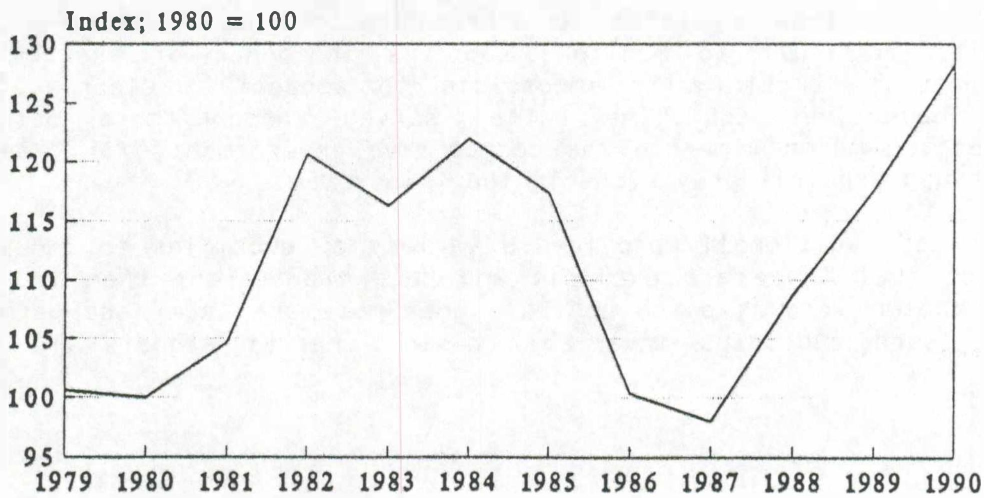


* Total economy unit labour costs relative to 20 industrial countries in common currency

Source: Commission services

Graph 8

Greece's international competitiveness in manufacturing*



* Manufacturing unit labour costs relative to 20 industrial countries in common currency

Source: Commission services

42.1% in the same period. This severe loss in competitiveness was partially offset through the 1985-87 stabilization program. The program was abandoned in the fall of 1987 and another nominal expansion commenced. Between 1987:Q4 and 1990:Q4 Greece's total economy real exchange rate rose by 16.3%, while that for manufacturing rose by almost 30% but there has been some modest containment of these trends in 1991. These developments are indicative of the very adverse impact of the labour market policies on Greece's ability to perform in international markets, and, more importantly, in the context of the European Community.

III.C Price Regulation and State Aids

A system of intensive price and profit controls was set in place in 1946 and governed Greece's price formation for over three decades; the system was codified in 1977. An extension of the regulations was implemented in 1979, covering a broader group of goods and services. Changes in the system were necessitated by Greece's persistent and high inflation. Prices were frozen for some time between the end of 1979 and the beginning of 1980, followed by a period of relaxation. However, new restrictions were initiated in 1982. In anticipation of the introduction of the VAT (on January 1, 1987), prices were frozen for the period November 1986-January 1987. In the subsequent years price regulation has been relaxed. At present, the weight of administered prices in the CPI is 31% (14% for public sector tariffs and 17% for private sector prices.

The fundamental motive for price controls has been to achieve social objectives, such as preserving the real income of wage earners, or providing wider access to various markets through influencing price formation. It appears that the policy has ultimately failed: inflation has been a constant threat to real wage gains, and the intensification of social strife is clearly related to price uncertainty; by creating a constituency, price controls become politically difficult to remove; finally, they have an effect on income redistribution which is not explicit, difficult to monitor, and the incidence of the implied subsidization is virtually impossible to assess(8). Clearly, such social objectives could be better served through more orthodox intervention means (improve the competitive environment, for example) and through explicit provisions in the tax system.

Greece has traditionally provided a variety of subsidies to industry. The fact that these are explicit and more transparent than indirect subsidization through price controls does not make them less harmful. Indeed, such subsidies invariably distort market signals and have

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(8) The difficulties encountered in the easing and ultimate removal of price controls has become particularly evident in the housing market. Here the income redistribution effected through rent controls has resulted in important professional constituencies which are contesting the proposed reforms. These reforms are discussed in the next section.

deleterious long-run effects on the allocation of resources. Apart from such considerations as competition policy and allocative efficiency, subsidization through the budget could have adverse budgetary and macroeconomic consequences.

Data on current transfers of general government to enterprises (Table 5) show that Greece occupies an intermediate position among the Community countries, with a mean value of current transfers to enterprises relative to GDP slightly higher than the Community average in the period 1976-85. The extent of subsidization increased steadily up to mid-1980s and then it started declining, probably because of the acute budgetary problems.

Table 5

Current transfers of general government to enterprises
(in % of GDP)

Period average	Greece	Eur-10*	Eur-12
1971-75	1.88	1.92	na
1976-80	2.68	2.28	na
1981-85	2.76	2.46	2.54
1986-90	2.12	2.16	2.16

* Community excluding Greece and Portugal

Source : Commission services

The results of the recent surveys carried out by the Commission on state aids (Table 6) show a much worse picture for Greece's relative position in the Community. Greece has the highest level of subsidization in manufacturing (measured either as its share in gross value added or as ECU per employee). According to the survey, Greece's distance from the second ranking country (Portugal according to the first measure, and Italy according to the second), let alone from the Community average, is so large that it confirms its position as the most generous provider of such subsidies among Member States.

The 1991 budget took steps to reduce subsidies to enterprises both in recognition of their budgetary burden and in response to the need to reduce state interference and to enlarge the room for market-determined production activities.

Table 6
State Aids in Manufacturing (period average)

	Greece		EUR-12	
	1981-86	1986-88	1981-86	1986-88
I. Aids to manufacturing as % of gross value added	12.9	15.5	4.8	4.0
II. Figures in I excl. steel and shipbuilding	13.9	16.4	4.0	3.8
III. Aids to manufacturing in ECU per employee	na	3545	1761	1515
IV. Figures in III excl. steel and shipbuilding	na	3721	1474	1439

Source : "Second Survey on State Aids in the European Community in the Manufacturing and Certain Other Sectors", Brussels, 1990

III.D Financial Policies and Capital Allocation

Greece's monetary policy has traditionally served the financial needs of the public sector. In the absence of well-developed financial markets and under extensive credit and interest rate regulations, monetary policy has contributed little to economic stabilization. In the 1980s, the increased credit demands on the part of the public sector effectively crowded out the financing of private capital formation. The Bank of Greece has initiated steps aimed at modernization and deregulation of the financial system in recent years; however, adverse fiscal developments had until recently retarded this progress since the short-term implications of interest rate decontrol for the public finances was regarded as potentially very serious. There have been some important steps to liberalize the financial system in recent months and progress is advancing at a satisfactory pace. These initiatives will bring Greece's financial system into line with the unified European financial area of 1993.

The financing of fiscal policy through the banking system has been determined through administratively set rules regarding secondary reserve requirements. Commercial banks are required to hold an explicit proportion of deposits in the form of Treasury bills. This amounted to 39%, but the deterioration in public finances made it necessary to raise it by 1 percentage point, to 40%, in March 1990. The loan decision requires that effective July 1, 1991 this will be reduced to 30%; on July 1, 1992 it will decline to 20%; and it will be phased out entirely by July 1, 1993.

The bulk of the outstanding Treasury bills is non-marketable, and a market-related, but preferential, rate of interest is paid by the government since the summer of 1987. Prior to that date, the Treasury bill rate was very low, and often lower than the rate paid on deposits. The maturity of the bills is determined by the Minister of Finance in such a way that the secondary reserve requirements are met. Since these instruments are rolled over at maturity, they effectively constitute long-term liabilities of the government; and, since the rate of interest paid is not commensurate to the character of these obligations, the government is able to finance its spending and deficit at preferential rates. In addition, commercial banks are required to extend privileges to other borrowers, while specialized credit institutions have obligations to contribute to the financing of public enterprises and entities.

Borrowing and lending rates have been negative in real terms over much of the previous two decades, while the spread between these interest rates has been very wide, even after accounting for intermediation margins(9). This is a reflection of the fact that Greece's financial system imposes implicit taxes, which are levied on both borrowers and savers, and which have risen sharply in the 1980s. A possible consequence of these has been the decline in the ratio of credit extended to the private sector by the consolidated banking system to GDP; the mean value of this ratio was 43.2% in the period 1976-80, but declined to 31.7% in 1986-89. This decline in the base upon which these implicit taxes are levied has parallelled the rise in the implicit tax rate applied; this rose from 2.2% in the former period to 3.8% in the latter.

There can be no a priori presumption that Greece's financial policies have encouraged domestic investment. Indeed, despite the interest rate subsidies granted and the low and often negative real interest rates(10), private investment performance, particularly in the second half of the 1980s, has been very poor. This paradoxical result appears to suggest that the interest subsidies have not been sufficient in stimulating private investment, or that even lower real interest rates would be required to achieve a given improvement in private enterpreneurship. It is also possible that other factors have

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(9) The mean differential between the lending and deposit rates in the 1980s is around 500 basis points; in the spring of 1990 it reached 700 basis points, and in May 1991 it was 900 basis points.

(10) The lending rate, the principal interest rate for short-term loans relevant for industrial borrowing, deflated by the CPI rate of inflation, had a mean value of -18 basis points in the period 1970-1980; it rose to 130 basis points in the period 1981-1986, and had a mean value of 370 basis points in the period 1981-1990/ This interest rate was liberalized in the summer of 1987 and has since risen very sharply.

dwarfed the potentially stimulative effects of financial policies in investment decisions. Indeed, it has been argued that Greece's financial policies have not been important in investment demand, and that private firms, instead of allocating credit extended to them towards financing investment at prevailing interest rates, they substitute it for retained earnings(11). Greece's financial policies, it appears, have simply distorted the allocation of capital without enhancing investment spending and economic growth. On the contrary, they have retarded significantly the process of financial liberalization.

Recent measures involve deregulation of deposit interest rates with the exception of savings deposits where a minimum rate has been retained; since saving deposits account for two thirds of total bank deposits this restriction continues to be important. Interest rates on bank lending to the private sector and to public enteprises are largely market determined and the regime of preferential credit extension to the latter has been abolished. Draft legislation is also in preparation aimed at modernizing banking and capital markets. In particular, it covers the second banking directive, the directive of solvency ratios for credit institutions, and the directive on own funds. The planned regulatory measures concerning the capital market will involve adoption of five Council directives; this legislation is expected to become law before the end of this year(12) .

IV. The Programme of Structural Reform

IV.A Greece and the Challenges of the 1990s

At the outset of the 1990s Greece is in an urgent need of adjustment and reform. These requirements, though fully motivated by the unsustainability of the present economic trends, have become even more pressing as new developments in the Community are undertaken. At this time, Greece faces three major challenges :

(a) the completion of the European Single Market by 1992
(b) the progress towards Economic and Monetary Union
(c) the possible enlargement of the Community to encompass several EFTA and Central and Eastern Europe countries.

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(11) This observation is from J. Dutta and H. Polemarchakis (1988) : "Credit Constraints and Investment Finance : Some Evidence from Greece", ch. 5 in M. Monti (ed.) : "Fiscal Policy, Economic Adjustment, and Financial Markets", IMF and Centro di Economia Monetaria e Finanzaria, Milan. The authors argue that a $1 increase in credit availability will yield only $0,04 of new investment and $0,96 of divident payments. In interpreting this behaviour they suggest that corporate savings finance the gap between the credit which is available and investment plans; should credit availability increase, firms reduce corporate savings and do not increase investment spending.

(12) A more detailed examination of issues covering Greece's financial markets and reforms is presented in Annex II.

The completion of the internal market by 1992 is the first challenge. A recent study(13) on the sectoral impact of 1992 in the individual member states revealed that among the least developed countries of the Community Greece is the least prepared for facing the challenge of 1992. Greece's external trade in the 1980s showed that of the 45 sectors identified as the most sensitive to the lifting of non-tariff barriers only 8 have shown a strong trade performance, while 37 sectors were found to be vulnerable (these sectors represent less than 20% of total value added and over 40% of employment). For the second half of the 1980s Greece's very weak investment performance contrasts with that of the other peripheral countries. At the same time, investment in modernising and expanding existing capacity and/or investment in new activities is a prerequisite for restructuring the production potential and adjusting to the geographical distribution of output emerging in the integrated European market.

The completion of the internal market is a further step in the ambitious process of economic and monetary union (EMU) undertaken by the Community. A prerequisite for EMU is economic convergence; nominal convergence is necessary for member states to exploit the gains from exchange and price stability, and real convergence is essential in order to improve the economic opportunities of the member states.

Greece's preparedness to participate in closer Community integration deteriorated over the 1980s. A synthetic indicator of convergence taking into account five major macroeconomic variables measuring the health of an economy(14) shows that Greece's position deteriorated from 38.5 in 1983 to 48.0 in 1989 and is projected to worsen further to 53.2 in 1991. Greece finds itself inadequately prepared to profit from the process of EMU.

The prospects of closer co-operation with, and possible enlargement of, the Community to encompass new members will increase competition and will create new opportunities for investment in human and physical capital. Greece's needs for foreign capital means that it will have to compete to attract international investment, but also to contain any potentially damaging brain drain. In addition, product competition from producers serving a larger free-trading area could marginalize weak and uncompetitive members. Unless urgent steps towards modernization are undertaken, Greece's prospects appear in this respect dim.

The medium-term economic programme of the Greek government, which formed the basis for the recent Community balance of payments loan, is to be seen and appreciated against the background of these multiple challenges. The 1991 stabilization programme has two broad objective: containment and reversal of the fiscal imbalance and of the

(13) "The impact of the Internal Market by Individual Sector : The Challenge for the Member States", <u>European Economy - Social Europe</u>, Special Edition, 1990.

(14) These indicators are inflation, budget deficit, public debt, unemployment and external current account. See P. De Grauwe, and D. Gros (1991): "Economic Convergence in the Community on the Eve of Economic and Monetary Union, <u>CEPS preliminary paper</u>, June.

macroeconomic deterioration, and the restoration of the economy's ability to produce through the initiation of structural reform measures, and, consequently, the betterment of the real income prospects of Greece's citizens(15). The programme is defined in terms of a specific timetable. In order to achieve the final objectives intermmediate targets for key macroeconomic and structural variables are set. Thus, the programme is specific and represents an exogenous constraint on the conduct of economic policy. Another feature of the programme is the conditional disbursement of the loan tranches in order to secure that not only the programme objectives are achieved, but also to monitor the progress of the programme implementation.

In aknowledging the importance of restoring the productive potential of Greece's economy, the programme places much emphasis on structural reform initiatives. These initiatives are intended not only to improve the medium-term productive ability of Greece, but also to generalize the acceptability of the stabilization programme by offering the prospect of improved economic opportunities and real incomes once the programme is complete. The experience of the 1985/87 stabilization made it clear that without steps to enhance Greece's productive prospects a stabilization programme would enjoy limited support and it would not be sustainable; furthermore, no lasting improvement in the underlying economic difficulties could be achieved without modernization of the productive structure and of the organization of economic activity.

The loan conditions stipulate that "the Greek government undertakes to provide, in consultation with the Commisssion, ... a timetable of legislative action over the adjustment period, to include the main elements in the proposed reforms:

(a) deregulation of goods, labour, and service markets;
(b) tax and social security reform;
(c) a reduction in the share of the wider public sector;
(d) capital liberalization in accordance with Community legislation"(16).

In order to satisfy these requirements a variety of measures have already been undertaken or are planned to be introduced in coming months.

IV.B Containment of the Public Sector

The influence of the public sector on Greece's economy has been pervasive and is of substantially greater importance than suggested by such simple measures as government consumption in GDP. A network of

(15) The fiscal consolidation measures are discussed in Annex I.

(16) See Official Journal of the European Communities, no. L 66/22, March 13, 1991.

interdependencies linking the state, state enterprises and entities, and financial institutions is the background against which private economic activity takes place. In this "state corporatist"(17) environment the distinction between the public and the private sector is blurred, since state intervention is a crucial factor in, and ultimately underwrites, private economic decisions. Greece's experience of rising public sector deficits, which are shifted between the central government and the wider public sector, supports the view that the budget constraints are "soft", with the public sector performing the role of the lender of last resort rescuing non-viable economic activities. This role increased in importance in the course of the 1980s entailing a variety of state interventions in the economy with the result that the country's output potential has notably declined.

An important characteristic of public sector behaviour in the 1980s has been its role as an employer. Table 7 shows the growth of civil service employment since the late 1970s. In addition, public enterprises and entities have also become prominent employers during the 1980s. These trends are suggestive of the increased dependence for employment on the public sector particularly in a period when non-agricultural employment was growing sluggishly.

Measures directed towards the containment of the public sector include an ambitious programme of privatization and steps to reduce public sector employment.

The contemplated programmme of denationalization, which was initially designed to privatize ailing enterprises, has been extended to include the sale of shares in public utilities. The programme is intended not only to improve the efficiency of the Greek economy and to reduce the budgetary costs arising from the support of these entities, but also to reduce public sector employment. The loan conditions postulate that the employment of public enterprises which are sold to private investors at 49% of their value will be counted as part of the employment reduction clause (point 3 of the loan condition).

The privatization programme has encountered a variety of legal and administrative difficulties and, despite the government's intentions, it has met with limited success so far. A critical element characterizing all public sector entities is lack of transparency concerning their accounting procedures, and this can affect adversely the potential sale of such entities. The government has yet to take steps to adopt accounting procedures consistent with generally acceptable transparency principles. In addition, the ownership of some enterprises now held by the Industrial Reconstruction Organization

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(17) This term is used by L. Katseli (1990): "Economic Integration in the Enlarged European Community: Structural Adjustment of the Greek Economy", in C. Bliss and J. Braga de Macedo (ed.): "Unity with Diversity in the European Community: The Community's Southern Frontier", Cambridge University Press, Cambridge.

Table 7
Trends in Public Employment
(thousands and percentage)

	Civil service (1)		Public enteprises & entities (2)	Civil service, % growth (3)	Public empl. [(1) + (2)] as % of non-agricultural employment (4)	% growth non-agricultural, non-public employment (5)
1977	215.0	(14.6)	128.8	na	14.5	na
1978	220.9	(14.8)	139.1	2.7	14.8	1.6
1979	227.8	(13.4)	140.2	3.1	14.9	2.0
1980	234.6	(13.9)	145.5	3.0	15.1	1.8
1981	240.5	(14.6)	153.0	2.5	15.0	4.3
1982	253.1	(15.5)	153.1	5.2	15.2	1.4
1983	263.7	(16.4)	156.7	4.2	15.8	-1.1
1984	268.1	(14.9)	162.1	1.7	16.0	0.8
1985	281.8	(10.5)	171.3	5.1	16.6	1.0
1986	285.3	(6.7)	171.9	1.2	16.6	0.8
1987	289.5	(6.4)	172.5	1.5	16.4	2.0
1988	289.7	(7.0)	173.2	0.0	17.2	-5.4
1989	311.2	(11.7)	176.2	7.4	17.8	1.4
1990	303.7	(10.4)	168.4	-2.4	na	na

Note : Civil service includes both permanent and temporary employees; the share of the latter in permanent and temporary civil service employees is shown in parentheses; na = not available.

Source : Budget Statement, November 1985; Budget Statement, November 1990; IMF : Greece : "Recent Economic Developments", May 1990; Eurostat : "Employment and Unemployment", various issues; and Commission statistics.

Table 8
Problematic Enterprises by Holder

Agricultural Bank	36
Commercial Bank	9
Industrial Development Bank	18
National Bank	12
IRO	54
Ministry of Defense	1
Ministry of Finance	2
Ministry of Industry	10
Ministry of Tourism	21
Ministry of Transport and Communications	7
Total	170

Source: Ministry of National Economy

Table 9
Some Characteristics of Enterprises under Law 1386/83
(DRS in billion)

	1982	1985	1986	1987	1988	1989	1990
Long-term obligations	30.1	150.4	131.2	23.9	28.4	17.4	20.6
Short-term obligations	81.2	102.9	111.1	92.3	117.8	174.3	209.1
Gross profits	8.7	17.9	26.4	19.7	14.6	22.6	26.3
Net income (loss)	(9.9)	(39.0)	(35.1)	(15.0)	(22.0)	(29.8)	(44.9)
(Cumulative losses)	(14.6)	(108.0)	(139.5)	(139.2)	(140.7)	(174.4)	(215.3)

Source: Z. Mavroukas (1991): "Industrial Policy towards the Problematic Enterprises in the 1980s: Results and Prospects", The Herald, June 16 (in Greek)

Table 10
Progress in the Privatization Programme

	end-May 1991
Total number of problematic enterprises	170
Available for sale by trade sale	104
Available for sale by public offer	3
In liquidation according to Law 1386/83	37
Other	26
Companies sold	7

Source: Ministry of National Economy

(IRO) has been challenged in the courts creating legal difficulties and raising questions about the feasibility of privatization in some cases.

The financial difficulties of Greece's enterprise sector deteriorated severely in the course of the 1980s, and with the state intervention of the early years of the decade several enterprises chose to discontinue operations. The government passed Law 1386/83 which was intended to invite firms in financial distress to apply to the IRO for restructuring. Between 1983 and 1987 the IRO received 250 applications, of which only 44 were accepted. The financial circumstances of these firms became subject to restructuring which involved a 36-month moratorium on debt payments and a plan converting debt for equity. As a result of this, Greece's financial institutions accepted in their portfolios assets of questionable value.

Table 8 shows the distribution of problematic enterprises by holder. Of the 170 enterprises available for denationalization 75 are held by banks and another 54 by the IRO. The remaining are held by various ministries, chief among which is the Ministry of Tourism (21 enterprises) followed by the Ministry of Industry (10 enterprises). Some characteristics of the enterprises under Law 1386/83 are presented in Table 9. These enterprises employed 26.6 thousand workers in 1989 and 20.7 thousand in 1990. During these two years bank loans amounting to DRS 107.9 billion and DRS 139.4 billion, respectively, had been used to support their operations. The enterprises have recorded losses throughout the post-1982 period and, as can be seen in Table 9, these had cumulated to DRS 215.3 billion in 1990, up from DRS 14.6 billion in 1982. Clearly, this financial situation is unsustainable.

The IRO has not been very successful in its denationalization efforts. Of its 54 enterprises 7 were sold by the end of May 1991 while, as shown in Table 10, much remains to be done. The key enterprise planned to be sold in 1991 is the Heracles Cement Works, a profitable firm in the sale of which there has been much interest expressed by investors(18). The sale of Heracles will determine non-tax revenue prospects this year since it is expected to yield around DRS 135 billion in net receipts(19). Progress in the IRO privatization programme was adversely affected by administrative difficulties in the summer of 1991, especially when its chairman resigned.

The government is planning to consolidate the financial operations of the public enterprises and the principal variables of the contemplated adjustment are shown in Table 11. A key adjustment is on the side of revenues, while expenditures are expected to rise at a slow pace. The revenue increases will be secured through increases in the prices of public enterprise goods, and the strict incomes policy is seen as

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(18) Heracles accounts for 3% of Community cement production and has over 40% of the domestic market. It is now 70% owned by the IRO with another 15-18% owned by various public sector banks; the rest is listed in the Athens stock exchange. About half of Heracles' annual production is sold abroad, and the company has excellent port facilities. In 1989 Heracles posted net profits of DRS 3,46 billion on sales of DRS 39,14 billion.

(19) More recent estimates have been markedly less than the orignal DRS 135 billion.

containing expenditure growth. Thus, the plan foresees that the large operating deficits recorded by these enterprises will be eliminated and a surplus of DRS 38 billion will be recorded in 1992 increasing further in 1993. Is is also projected that the squeeze in the investment budget will only occur in 1991; in subsequent years the programme provides for real investment increases of 3% per annum.

There are plans to sell shares in public utilities as well. The principal entities are the Public Power Corporation and the Telecommunications Organization. While the government had hoped that these transactions would take place in late 1991 and in 1992 it now appears unlikely that this will be the case. The preparatory framework for the sale of shares in utilities is not complete. Prior to such sales it is required that the regulatory framework is in place; this has as yet to be prepared. In addition, the true picture of their financial circumstances have to be clarified. Sales of utilities are likely to take place from 1993 onwards, and the revenue potential from such sales will likely be very substantial.

Table 11

Medium-term Consolidation Plan for Public Enterprises, 1990-1993
(DRS in billions)

	1990	1991	1992	1993
Operating account				
Revenue	1269.0	1625.0	1855.0	2016.0
Expenditure	1422.0	1637.0	1817.0	1971.0
Operating deficit	153.0	12.0	-38.0	-45.0
Capital account				
Revenue	-	-	-	-
Expenditure	483.0	509.0	579.0	643.0
Capital account deficit	483.0	509.0	579.0	643.0
Total deficit	636.0	521.0	541.0	598.0
(% GDP)	(6.0)	(4.2)	(3.7)	(3.6)
Total Financing	460.0	467.0	527.0	594.0
of which:				
Grants from central budget*	161.0	142.0	156.0	181.0
European Community funds	42.0	39.0	45.0	56.0
Net borrowing requirements	176.0	54.0	14.0	4.0
(% GDP)	(1.7)	(0.4)	(0.0)	(0.0)

* Ordinary and investment budget

Source: Ministry of National Economy

IV.C Tax and Social Security Reforms

Tax Reform

Greece's tax system is composed of a large number of regulations which have multiplied in recent years as a result of efforts undertaken to combat tax evasion and increase revenues. Widespread tax evasion and fraud have reduced the revenue potential of the tax administration system while a considerable number of taxpayers is outside the tax base altogether. There can be no presumption that the tax system is neutral in its effects on resource allocation and the OECD has remarked on the relatively higher tax rates in Greece compared to the OECD average and the small share of tax revenues relative to the tax base[20]. The tax base does not include farmers and the generous tax exemptions have made it even narrower. The net impact of the tax regulations on incentives to work, save, and produce, let alone to pay taxes, has been adverse as manifest from the budgetary developments in recent years. These trends in tax revenues over the 1980s, as well as the erosion of tax and fiscal ethics, indicate that Greece's tax system is in urgent need of reform. The loan conditionality places tax reform at the top of the modernization steps.

Progress towards a new tax code has been very slow. So far only broad statements about the intended rationalization of the tax code, with the view of enhancing its equity and improving its allocative function, have been made by the government. Recently two working groups have been established to review the requirements and make proposals for reform. The reforms will cover the personal tax code. There is uncertainty about the proposals of the working groups and how binding they will be for the government's tax policy. Greece's approach to tax reform is piecemeal and lacks a coherent evaluation of the possible economic effects of the contemplated measures. There is need for a comprehensive and rational approach to the tax system, and the planned measures so far fall short of the required initiatives.

Social Security Reforms

Greece's social security system has experienced chronic difficulties, the principal source of which have been: demographic changes, widespread evasion of contributions, extension of pension rights to individual of dubious qualifications, early retirement at full pension, low contributions over much of the system's history, above-inflation increases in pension disbursements during much of the 1980s, and the linkage of pension payouts with wage settlements in negotiations. These have contributed to real increases in pensions over much of the 1980s

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(20) See OECD (1990) : "OECD Economic Surveys : Greece", Paris.

which, in view of the revenue shortfall, have made the social security system virtually insolvent.

The principal entity of the social security system is the Workers Social Insurance Organization (IKA), while as many as another 300 private funds are also in operation. In the course of the 1980s pension expnditures advanced rapidly so that by 1989 they amounted to around 15% of GDP, or more than twice as much as at the end of the 1970s. The widening deficits have burdened the central government budget increasingly over the years. For example, grants from the central government budget financed 40% of the operating deficits of all public entities in 1986, rising to 66.8% in 1990; the 1991 budget estimated that this would fall somewhat to 58.2% however. The net borrowing requirements of all public entities rose from DRS 82.8 billion in 1986 to DRS 162.5 billion in 1990, and the 1991 budget estimated a further increase to DRS 229.9 billion in 1991. Clearly, these trends are very worrying since they leave little doubt about the unsustainability of the underlying policies.

The government initiated reforms in September 1990 as part of a first package of measures aimed at restoring the viability of the system. The measures increased contribution rates (by 1 point to 5.7% for employees, and by 2 points to 11.5% for employers); tightened eligibility criteria for disability pensions; increased the contribution period (from 13.5 years to 15 years in the private sector, and from a wide range of between 15 and 30 years to 25 years in the public sector); increased the minimum pensionable age in the public sector (to around 60 years of age, to apply to public sector employees according to whether they joined the public service before or after 1983); and linked pension increases in the private sector to the rate of wage increases in the public rather than in the private sector. These measures, in effect, allowed for some significant real declines in pension disbursements which are expected to extend over the adjustment period 1991-93.

Since the containment of the deterioration in the financial position of the social security system relied to a large extent on real pension declines, a second package of reforms has been contemplated. The new measures are essential to secure the sustainability of the reforms and the long-term viability of the system. The government has been slow in initiating the new measures. A process of social dialogue has only recently been initiated, and a Scientific Committee involving the social partners is expected to report in October. However, the nature of this report and how the government intends to treat its potential recommendations have not been spelled out.

Tables 12 and 13 present the consolidation plans for the public entities as a whole and for IKA in particular. The plans require that the net borrowing requirements of the public entities will not exceed 1.5% of GDP over the adjustment period, and that revenue increases (63% between 1990 and 1993) will strengthen their financial position. Expenditure is projected to increase by 44% between 1990 and 1993, while grants from the central government are projected to decline in nominal and real terms. There is a large increase in Community support funds. The consolidated deficit of the public entities is expected to stabilize at around 4.7% of GDP.

Table 12
Medium-term Consolidation Plan for Public Entities, 1990-1993
(DRS in billions)

	1990	1991	1992	1993
Operating account				
Revenue	735.0	930.0	1076.0	1195.0
Expenditure	1216.0	1474.0	1599.0	1751.0
Operating deficit	481.0	544.0	523.0	556.0
Capital account				
Revenue	-	-	-	-
Expenditure	31.0	51.0	52.0	58.0
Capital account deficit	31.0	51.0	52.0	58.0
Operating deficit	512.0	595.0	575.0	614.0
(% GDP)	(4.8)	(4.7)	(3.9)	(4.7)
Total Financing	349.5	365.2	362.0	367.0
of which:				
Grants from ordinary budget	321.0	316.0	312.0	312.0
European Community funds	19.0	43.0	49.0	54.0
Net borrowing requirements	162.5	229.8	213.0	247.0
(% GDP)	(1.5)	(1.8)	(1.5)	(1.5)

Source: Ministry of National Economy

IKA's planned consolidation involves a 60% increase in revenues (58% rise in contributions) between 1990 and 1993, while overall expenditure is expected to increase by 42%. Pension disbursements are to rise by only 30% over this period, but interest payments are set to rise by almost 90%, reflecting the financial obligations accumulated by IKA over time. The government has also established a monitoring system to determine better the flow of revenues and expenditures of public sector bodies, and IKA is subject to this monitoring procedure. However, it appears that although expenditure control has improved, failure to pay contributions, particularly on the part of other public sector bodies, has made the revenue prospects uncertain.

The government undertook debt consolidation operations involving state guarantees which had fallen due by the end of 1990; of the DRS 625 billion subject to consolidation, DRS 276 billion involved two social security funds, IKA and the Seamen's fund (NAT). Despite these measures, the financial position of these entities remains precarious with no visible improvement as yet in place. It is expected that IKA's borrowing needs in 1991 will be double those initially projected, a reflection of the lack of effective implementation of measures already taken. In view of these developments, the overall consolidation plan for IKA and the public entities may not be entirely credible. The reform of the social security system, which was boldly initiated in 1990, has prodeced at a very timid pace even though the need for reform remains urgent.

Table 13
IKA's Consolidation Plan, 1990-1993
(DRS in billions)

	1990	1991	1992	1993
Operating revenue	529.4	668.0	770.0	847.0
of which:				
Social insurance contributions	470.9	597.0	674.5	742.0
Supplementary contributions	56.1	68.0	77.0	84.0
Other	2.4	3.0	18.5	21.0
Operating expenditure	897.6	1077.6	1164.0	1275.0
of which:				
Pensions	575.0	678.0	695.0	750.0
Interest payments	133.5	177.0	220.0	252.0
Other	189.1	222.6	249.0	273.0
Operating deficit	368.2	409.6	394.0	428.0
(% GDP)	(3.5)	(3.3)	(2.7)	(2.6)
Total Financing	193.1	180.1	180.1	180.1
of which:				
Grants from ordinary budget	193.0	180.0	180.0	180.0
Net borrowing requirements	176.6	232.0	216.4	250.9
(% GDP)	(1.7)	(1.8)	(1.5)	(1.5)

Source: Ministry of National Economy

IV.D Deregulation of the Goods and Labour Markets

Measures in these areas involve deregulation of the oil market, easing and reform of the regulatory framework governing the housing market, and deregulation of the labour market.

The Oil Market

The oil market is to be fully liberalized in 1991 in accordance with loan condition 5. The proposed reforms involve liberalization of retail prices for fuel, fuel import liberalization, and the establishment of a fuel consumption tax fixed in absolute terms. The deregulation of the oil market is complicated by the presence of two state-owned refineries which have a monopoly in the domestic market; by the fact that oil consumption in remote areas of Greece must be secured at below market prices; and by the Community minimum oil reserve requirements which must be met.

The intention to deregulate the oil market was announced in July 1991, but legislative proposals are as yet to be made. However, much remains to be achieved before deregulation is fully attained. In particular, not only the relevant Community legislation must be respected, but also a variety of legal, technical, and administrative hurdles must be overcome before the deregulation steps are made effective.

The Housing Market

Deregulation of the housing market has already commenced. Despite the acrimonious disputes between the government and professional groups which have dominated the summer months, the government has taken some bold measures to ease the extensive controls characterizing Greece's housing market.

In June 1991 the government initiated legislation as a result of which as much as 40% of Greece's housing market is now free of rent controls. For the remaining, rent increases allowing for greater market influences are provided for. New buildings, buildings newly rented, and buildings which have remained vacant for more than one year, as well as houses or apartments with an objective value of DRS 30 million or purchased with foreign exchange, and those with a surface of over 120 m^2, will be free of rent controls. For the remaining, rent increases of 12% on July 1, 1991, and 8% on July 1, 1992 have been proposed. The intention of the government is to undertake additional reform measures in two years time so as to increase the supply of housing particlarly in urban areas where a housing shortage has been chronic. Despite a variety of difficulties with lawyers and doctors, steps to liberalize rents of buildings used for professional activities were presented in the form of a parliamentary bill in August 1991.

Reforms in the Labour Market

Steps to reform labour market relationships have so far been timid, although there have been efforts to reduce the role of the public sector in wage formation. In indirect ways, the attractiveness of the public sector as an employer has perhaps been reduced, but Greece's youth continues to regard jobs in the public administration as particularly desirable. At the same time, the supply of such jobs by the politicians encourages the ideology of dependence. These explain the persistence of clientelism and the difficulties involved in establishing a less politicized process of employment and a more efficient public administration. In view of the leadership role played by the public sector in a variety of labour market processes, reform of public sector employment is very important.

Table 14
Labour Market Trends
(percentage change over previous period and percent)

	1985	1987	1988	1989	1990*	1991*
Total employment	1.0	-0.1	1.6	1.5	0.4	-0.4
Compensation/head	23.2	9.7	18.5	19.5	21.3	15.6
Real compensation per head	4.1	-5.1	3.7	4.1	0.6	-2.0
Unit labour costs	20.6	10.1	15.7	17.9	22.2	14.2
Unemployment rate	7.8	7.4	7.6	7.5	7.5	8.7

* Commission forecasts April-May 1991

Source: Commission services

The three-tier wage negotiation process continues to dominate Greece's labour relations. In the first place, the minimum wage is set by a national collective agreement involving the Greek Federation of Industries and the Greek General Federation of Labour. Secondly, employees organized by trade negotiate wage increases on the basis of seniority, credentials, etc. Here the powerful banking and electricity unions have played a dominant role. Finally, negotiations at the plant or local level provide for productivity increases. This system has produced high wage inflation, substantial increases in labour costs in excess of productivity, and has eroded Greece's competitiveness. Also, resort to strikes by the banking and other unions have had a disastrous effect on economic stability and performance.

The principal labour market measure introduced by the government has been the abolition of the wage indexation mechanism (ATA). In addition, the arbitration boards which were dominated by the government representatives are now replaced by professional mediators; their role is to assist in conflict resolution in an impartial manner. The policy of granting wage increases of 4% on January 1, 1991 and 4% on July 1, 1991 and the general stabilization climate, contributed to the signing of a collective agreement in the private sector providing for moderate wage increases over the period to the summer of 1992. This is the first stage of negotiation and it has been followed by similar moderate agreements at lower levels(21). The acceptance of this agreement is in sharp contrast to the tradition of wage settlements in excess of official inflation projections and possibly confirms that the stabilization programme enjoys credibility.

(21) The agreement was approved by the Greek General Federation of Labour in March 1991 and provided for nominal wage increases of 6,9% on January 1, 1991; 5,6% on July 1, 1991; 5,4% on January 1, 1992; and 5,2% on July 1, 1992. It was also agreed that if inflation exceeds the official projection appropriate compensation will be granted.

Greece's experience with strikes, and especially with public sector strikes (such as electricity or bank employees) has been dismal. The 1990 initiatives have been aimed at curbing the propensity to strike and, in this respect, the legislation provides that if the court declare a strike illegal workers, including permanent civil servants, can be dismissed. Furthermore, various other measures are devised to enhance union leaders' accountability.

There have been no reforms of the legislation governing layoffs. Greek workers appear to enjoy considerable protection under the law and the Ministry of Labour can reverse decisions to layoff large mumbers of workers (equivalent to 2% of the labour force in one month). On the other hand, the system regulating working hours and part-time work is under review. The legal framework has been prepared to permit a fourth shift, while shopping hours have been liberalized.

IV.E Liberalization of Financial Markets and of Capital Movements

Liberalization measures covering the area of banking and financial services have been introduced at a good pace. Steps were first introduced in 1987 in response to recommendations from the Committee on the Reform and Modernization of Greece's Banking System. These recommendations indicated the need for interest rate deregulation, the gradual abolition of secondary reserve requirements, and the removal of credit controls. Despite progress made so far, Greece's financial system remains underdeveloped.

All deposit rates are now market-determined except a minimum rate on saving deposits has been retained; since saving deposits account for two thirds of overall bank deposits, this remains an important restriction. Furthermore, banks are not allowed to freely dispose of more than 50% of their resources; this restriction involves the compulsory investment of deposits in Treasury bills, the financing of the handicraft sector, and the minimum reserve requirements for reasons of monetary policy. The setting of interest rates on Treasury bills is now influenced by market conditions to a greater extent than previously, and this has been a welcome development in the removal of financial repression policies. A variety of rules governing credit allocation have also been abolished with the exception of the remaining restrictions on consumer credit. Finally, the Bank of Greece is now allowed to engage in repurchase agreements and Treasury bill auctions, thus extending its monetary policy instruments and enhancing its role in the setting of monetary policy.

The adaption of Greece's legislation to Community directives has been undertaken at a vigorous pace. Draft legislation has been prepared covering the second banking directive, the directive on solvency ratio for credit institutions, and the directive on own funds. These are essential steps in view of the unified European financial area of 1993. There are some institutions which have been slow in adapting to the new financial environment, however. For example, there are difficulties in meeting the 8% capital/asset ratio required by the directives by some state-owned banks, even though most other banks have already achieved this. Similarly, concerning the restrictions imposed by the second banking directive(22), the National Bank of Greece has failed to comply. The general assessments of the current developments is that Greece's banks are preparing to integrate themselves in the European financial area and that progress in this respect is encouraging.

Effective May 6, 1991 Greece removed restrictions on capital movements and on tourist allowances which were subject to a derogation under Article 106 of the Treaty. These measures, which were taken as part of the loan conditionality, liberalized fully tourist expenditures, the use of credit cards abroad, capital transactions for the acquisition of property abroad, and capital transactions for purchases of foreign long-term securities. The Commission abrogated the derogation in Greece's favour on June 6, 1991.

As a result of these measures Greece's integration with the European financial area has been enhanced. Furthermore, pressure to modernize the domestic financial and non-financial markets at an accelerated pace will undoubtedly become more pronounced. As regards short-term capital transactions, Greece retains various restrictions; these could be in place up to the end of 1992, according to Community directives. As well, Greece's restrictions vis-a-vis the non-Community world remain so that the liberalization measures undertaken cover only part of the country's international capital transactions. Although it is conceivable that the liberalization of long-term capital transactions could adversely affect Greece's capital account, there is no evidence that this is happening.

V. <u>Conclusions</u>

The 1991 stabilization and structural adjustment programme adopted by the Greek government is the first serious effort to reverse the country's macroeconomic decline and restore its productive potential. The gap which has developed between the Community and Greece must be bridged if the Greece's prospects for participating in the next stage of European integration are to improve. The measures of fiscal adjustment and structural reform are interdependent: in order to achieve the adopted targets and sustain the stabilization efforts both components of the programme must be implemented. Fiscal adjustment without structural improvements is unsustainable; similarly, structural reforms will be entirely ineffective if the fiscal imbalances are not contained.

Following six months of fiscal retrenchement Greece's macroeconomic prospects have worsened. The restrictive monetary, fiscal, and exchange rate policies have contributed to a weakening in economic activity and have accelerated the process of disinflation. Recent trends indicate that the rate of inflation, which was 18.1% in June, will likely ease further as the year progresses. The external deficit has also narrowed while capital inflows has been strong. The cumulative external deficit

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(22) These require that no more than 60% of a bank's capital can be invested in a non-financial business, and that no more than 15% of a bank's capital can be invested in any one non-financial business. On the second banking directive, see <u>Official Journal of the European Communities</u>, no. L 386/1, December 30, 1989.

in the period January-May 1991 is US$ 2038 million, and net capital inflows US$ 2237 million. Overall, current macroeconomic prospects appear more optimistic than initially estimated as far as the inflation and external balance targets are concerned.

However, the sustainability of these gains is by no means guaranteed. It has become evident that neither the programme of fiscal adjustment nor that of structural reforms are on course. Serious deficiencies continue to characterize the tax collection and administration mechanism, and serious delays have emerged in the implementation of the planned structural initiatives. Indeed, in the crucial areas of tax and social security reforms, as well as in the intended improvements of the tax collection management, Greece is not undertaking the necessary measures at a pace which would make it possible to meet the programme objectives. Such failures in budgetary adjustment and reform are raising the prospect of substantial deviations from the targets and, more specifically, it is likely that the revenue expectations for 1991 will not be met. Since the government will have to finance a deficit in excess of the programme projection through an expanded programme of Treasury bill sales debt service payments will also exceed the ex ante estimates. In turn, the prominent presence of the public sector in the absorption of Greece's savings and the rising indebtedness, in the context of financial market liberalization, will continue to sustain the already high real interest rates and will have very deleterious consequences for Greece's growth prospects. Thus, failure to achieve the budgetary targets will raise the prospect of continuing financial and macroeconomic instability. Clearly, achievement of next year's targets will be even more difficult and greater stabilization efforts will be required to even remain within the programme objectives. Finally, insufficient containment of the fiscal imbalances will make the restrictive monetary and exchange rate policy unsustainable, and will erode the credibility of the whole programme. After the experience of the 1985/87 stabilization Greece can ill afford to undermine its meagre credibility capital.

This study has emphasised that a vigorous fiscal expansion and a deteriorating output capacity have been the twin forces which undermined Greece's prospects to improve its standards of living in the 1980s, and to take advantage of the opportunities offered by its membership in the European Community. These difficulties continue to characterize its current economic prospects. The lack of political will to decisively dismantle the various regulations governing Greece's economic activity, and to offer a novel orientation whose central feature must be a restructured public sector, become a major stumbling block to progress. There is no evidence that a change in regime, so urgently needed, has occurred. Indeed, it is not certain that it will take place in coming months. The ineffectiveness in promoting adjustment and reform will only become apparent when another stage in Greece's macroeconomic decline will impose severe constraints on the policy choices. Postponement of adjustment means that greater sacrifices must be made later.

Seen from the current perspective, Greece's prospects of closing the gap with the Community and fostering real convergence are not encouraging. The planned reforms continue to be the government's intentions but few have become a reality. The modest nominal convergence likely to be achieved in 1991 will not be sustainable and price stability will not be secured without the emergence of a competitive productive economy in Greece. Failure to foster price stability and real convergence with the Community will have far reaching implications and will adversely affect the real income prospects of Greece's citizens at a time when the rest of the Community is advancing to the next stage of integration.

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