COMMISSION
OF THE EUROPEAN
COMMUNITIES

Directorate-General
for Economic and Financial Affairs

Brussels, 1 July 1991

II/313/91-EN

CONFIDENTIAL

α) Γιατί είναι βασικό ο περιορισμός των ελλειμμάτων. Επειδή δεν πέτυχε ο περιορισμός κατέρρευσε το σταθεροποιητικό πρόγραμμα της οικονομίας

β) Δεύτερος Πόλος - διαρθρωτικά (αυτά που δεν έκαναν - κείμενο)

γ) Τι πρέπει να γίνει. Επανάληψη θέσεων.

GREECE'S STABILIZATION PROGRAMME

A MID-YEAR REVIEW

(Note for the attention of the Monetary Committee)

- Τελευταία στοιχεία
- Ποια τα σημεία κριτικής που ξεπερνούν την κριτική της Κοινότητας

γύρω στο 60% της δαπάνης

δαπάνη που ~~προσδιορίζει~~ ΑΕΠ

α) - ιδιωτική & δημόσια κατανάλωση

β) - δαπάνες για επενδ. (ιδ. + δημ + αποθεμ.)

γ) - εξαγωγές αγαθών και υπηρεσιών (μόνο 15% της συνολικής δαπάνης) → στην Ολλανδία 60%

αρνητικά δαπάνες για εισαγωγές

σταθεροποίηση μειώνει ιδιωτ. καταν. (μισθοί)

β) επενδύσεις μειώνουν σήμερα

γ) → προσδιορίζονται από ανταγωνιστικότητα

εξαρτώνται συνολική ζήτηση (από κατανάλωση) profitability (έχει χρονική υστέρηση)

αύξηση παραγωγικότητας χρειάζεται χρόνο

βελτίωση της ανταγωνιστικότητας και της αποδοτικότητας (profitability) των επενδύσεων

να προωθήσουμε επενδύσεις

ανακατανομή του εισοδήματος εις βάρος των παρασιτικών - παραοικονομίας μεταπρατικοί και όχι εις βάρος παραγωγικού (υγιή) τομέα της οικονομίας υπηρεσίες.

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GREECE's STABILIZATION PROGRAM

A mid-year review

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GREECE's STABILIZATION PROGRAM

A mid-year review

I. SUMMARY AND CONCLUSIONS

Greece's stabilization programme is currently off course. Seen from a mid-year perspective, several key 1991 targets are now unattainable. Effective action to signal a regime change and to restore the country's public finances to sustainability is lacking, and action to promote structural reform has been inadequate and ineffective. Failure to meet this year's objectives threatens next year's targets as well. The likely deviations from the 1991 targets may be such that the 1992 targets are out of reach.

The principal areas of failure are budgetary adjustment, structural reform initiatives, and budgetary reform. It is likely that revenues will fall short of target by a substantial amount, while there is a high probability of an expenditure overrun. The implication is that the 1991 central government deficit could exceed the program target by more than DRS 400 billion (The projected reduction in the deficit for 1991 is DRS 500 billion). Such a deviation from target, which would yield a reduction in the deficit of 3,4% of GDP compared to the 6,6% of GDP reduction forseen in the programme, is clearly difficult to accomodate within the existing program objectives since it will require a much larger than initially assessed adjustment in the remainder of this year and in 1992.

Macroeconomic Developments

The restrictive macroeconomic policies pursued will likely yield a better than expected inflation and balance of payments performance, while real output growth is expected to be anaemic and unemployment to rise. As a result of the failure to foster budgetary adjustment and structural reform, however, the superior price and external performance will be short-lived and unsustainable, and the credibility of the restrictive monetary and exchange rate policy will come into question.

Budgetary Adjustment

The budgetary adjustment envisaged by the loan condition will not be achieved. There are serious difficulties in attaining the revenue targets stemming from the decline in nominal income growth, from the failure to combat adequately tax evasion and to collect tax arrears, from the failure to widen sufficiently the tax base, and from a variety of problems encountered in the collection of non-tax revenues. The revenue shortfall could be in the range of DRS 300-400 billion.

There are also pressures making it difficult to maintain the necessary expenditure control. Expenditure overruns are likely in debt service payments while there is also intense pressure to increase recruitment. The dollar appreciation, and the increased use of Treasury bills to finance budgetary needs, has meant that the ex ante projection for debt service payments will be overshot. The government's incomes policy appears to be working. However, the objective of recruiting one employee for every two leaving the public sector is clearly not being respected and also the existence of a large number of authorizations to recruit could eventually translate into a sizeable increase in public sector employment. Overall, it is possible that expenditure could exceed the target by over DRS 100 billion in 1991.

The likely overshooting of the central government deficit target is in the range of DRS 400-500 billion.

Public Enterprises and Entities

Although provisional data do not reveal any divergences from targets in the first four months of the year, Greece's public enterprises and entities are in serious financial difficulties. There are risks of expenditure overruns and it appears that arrears are continuing to accumulate.

The April consolidation operation, involving DRS 625 billion of guaranteed debt which fell due by the end of 1990, went some way towards containing the deterioration in the financial relationships involving banks, the state, and the public enterprises and entities but there remain serious problems of lack of transparency. New arrears will require that additional consolidation operations will have to be implemented in the future. Currently it is expected that unguaranteed debt held by the Agricultrual Bank of Greece (DRS 326 billion), as well as debts of agricultural co-ops of an as yet undetermined amount, will be consolidated. Lack of transparency and the absence of discipline continue to characterize the financial circumstances of public enterprises and entities.

Structural Reform

Progress on structural reform has been slow and the loan commitments will not be met in a formal sense. There have been delays in the preparation of the reform plans, and a comprehensive framework within which the relevant measures are to be placed is lacking. Measures to attain deregulation of the oil market are to be taken, but there remain a variety of difficulties in this area; progress is made towards deregulation of the housing market, even though some measures have been contested by various professional groups; on the other hand, the freeing of Greece's financial system is progressing at a good pace.

The plans for tax reform are difficult to evaluate, and progess in this vital area is very slow. Two consulting groups have been set up to make proposoals which the government hopes to put into practice in January 1992. There has been as yet no analysis of the economic effects of prospective reforms which, at this stage, are not definite. Reform of the social security system is also urgently required, but the government has approached these issues without a clear commitment. There is uncertainty about how the government intends to respond to the urgent financial problems confronting the public pension system, while implementation of reform measures already taken appears to be ineffective. The government has set up a Committee involving the social partners which is expected to report on social security reform in October.

The government's privatization plans are delayed by various legal and administrative hurdles. The sale of entities held by the Industrial Reconstruction Organization (IRO) has encountered difficulties while, it appears, that the necessary skills to execute such sales are lacking in the relevant Ministries. It is also essential that the appropriate regulatory framework is set in place before the sale of shares in utilities actually begins; progress in these matters has been slow.

Monetary and Exchange Rate Developments

Monetary and credit developments so far this year have been consistent with the ex ante targets. The taxation of deposit interest income has led to a pronounced shift in favour of tax-exempt public debt; this, however, is unlikely to continue once the stock adjustment is over. Holdings of bank deposits have been reduced markedly and consequently the compulsory investment by banks in Treasury bills has also declined. Domestic bank lending to the private sector has been slow, even though there is evidence that borrowing from abroad is rising. Such international borrowing could undermine the tightness of the monetary programme.

The appreciation of the dollar has meant that the drachma/dollar exchange rate has risen sharply in recent months; relative to ERM currencies the drachma depreciation has been much less pronounced. On the basis of consumer prices the drachma real exchange rate depreciated somewhat in the first quarter of 1991, but it has appreciated when measured on the basis of wholesale prices.

Conclusions

The medium-term programme presented to the Community in the context of the balance of payments loan application was designed to rectify the serious economic problems of Greece through the pursuit of budgetary and public sector financial adjustment and of structural reform. In both areas, but particularly with respect to budgetary adjustment, which is crucial to the achievement of a sustainable improvement in the performance of the Greek economy, there are shortfalls with respect to the targets set out in the programme. The shortfall in budgetary adjustment is serious, and the financing of a higher than anticipated fiscal imbalance together with underlying trends in recruitment pose serious problems for 1991 as well as 1992. In addition the financial situation of the wider public sector is unclear and there can be no certainty as to whether improvements are taking place and, if so, to what extent.

Given the size of the budgetary deficit and the rapid accumulation of public debt in Greece there is a minimum threshold of adjustment which has to be achieved if continued deterioration is to be avoided. This was a key objective of the medium-term programme with its emphasis on front end adjustment. Although over the past 12 months a number of, often difficult, measures have been taken these have not been sufficient to avoid a continued underlying deterioration in the public sector finances. An emergency programme of rectification is now required if the adjustment programme is to be put back on course. This will need to involve immediate short-term measures and a much more convincing implementation of the measures contained in the programme.

Underlying the failure to achieve the targets are a number of features in the Greek political and administrative system. The massive demands for recruitment and the incapacity to resist the pressures indicate that the political system has not adapted to the needs for adjustment. Furthermore there is a clear lack of coordination in government and between Ministries. Finally, the administrative system does not seem to be able to implement the intentions of the authorities effectively. All of this implies an urgent need for a regime change in Greece, without which there can be little optimism in the capacity of the political system to achieve adjustment.

The impact of programme failure on the economy of Greece will be adverse. The overshooting of the 1991 public sector deficit implies that public sector demands on Greece's savings will remain large, maintaining the upward pressure on real interest rates. The high real interest rates are one factor exerting an adverse impact on the country's investment spending. The implication is that the country's longer term prospects are severely affected and potential output growth, which was anaemic in the 1980s, will not recover. Consequently, an adverse configuration of high real interest rates and low real output growth appears to characterize Greece's macroeconomic prospects, making a sharp increase in the debt/GDP ratio more likely than the decline projected in the stabilization programme. Under these circumstances, the erosion of the standards of living which has taken place over the past decade is likely to continue, and Greece's divergence from the rest of Community will widen.

Recent macroeconomic trends show that in 1991 a weakening economy will produce both lower than expected inflation and a better balance of payments performance. However, these gains will prove transitory and unsustainable if no effort is made to place them within a firm improvement in the country's ability to produce. The large demands from the public sector deficits will continue to halt growth prospects, to distort the allocation of domestic savings, and to undermine the counter-inflationary monetary and exchange rate policy. Indeed, the credibility of the current policies will not be sustained in the face of persistent fiscal imbalances.

The absence of effective action to improve the transparency of financial relations of the government with the public sector entities, enterprises, and financial institutions, and the apparent difficulty in placing under control the spending of public sector bodies while strengthening their ability to collect revenues, have emerged as areas where major defficiencies are present. The government undertook a debt consolidation operation in April. The implications of this operation have not been well-studied. Continuing lack of control and persistent public sector deficits could make this erosion more pronounced.

With the failure to introduce an effective change in the regime governing taxation and expenditure control, no fiscal reforms of consequence have been implemented so far in the adjustment programme. Since an objective of the programme was to front load the adjustment so as to secure improvements early in the programme and to minimize future stabilization efforts it is certain that substantially greater efforts will be required in order to simply remain within the adjustment framework. It is imperative that such efforts are committed at once. Because if they are not, not only the implementation of the adjustment programme (which formed the conditionality of the balance of payments loan) but, more generally, Greece's preparation to participate in the second stage of economic and monetary union, and to raise the real incomes of its citizens, will recede out of reach.

II. MACROECONOMIC DEVELOPMENTS AND PROSPECTS

The restrictive macroeconomic policies pursued since Spring 1990 have resulted in gradually weakening economic activity. All available indicators point to a recession and this is reflected in the evolution of both volumes and prices.

In 1990 output fell by 0,4% (GDP at factor cost), agricultural output dropped sharply (-10%) because of climatic conditions, manufacturing output declined by 2,6%, while in construction and services activity slowed down. Prospects for 1991 are also gloomy for the urban sector of the economy. However, the rebound of agricultural output (an estimated 8%) is expected to more than offset a further decline in industrial output (-1,5%) and construction activity on the one hand and a very weak growth in services (of the order of 0,5%) on the other. Overall, GDP is expected to grow by only 3/4%.

On the demand side developments in 1991 so far have been characterized by very depressed retail sales (in the fist quarter they dropped by 8% in real terms); on the other hand, private consumption has been sustained by the continuous boom in car sales reflecting the granting of specific tax incentives for environmental purposes. Thus, private consumption is estimated to rise in 1991 by less than 1% and this would imply, given the fall in real disposable income, a sizeable decline in the savings rate.

Public consumption is restrained in the context of the fiscal adjustment programme which provides for a fall by over 2% in real terms. This, however, will mainly depend on the evolution of public employment. Investment is expected to slow down reflecting both weak demand and high financing costs. Residential construction will be depressed for a number of reasons including cyclical factors, demographic trends and various tax measures affecting real estate. Business investment, as evidenced by survey results and the evolution of imported machinery in the first quarter of 1991, is not expected to slow much compared with the previous year. Private investment seems to be sustained by good profits in recent years. Public investment is set to rise by 5% in real terms.

The foreign sector will make a positive contribution to GDP growth in 1991 if the prevailing trends in the external accounts are confirmed. In the first four months of 1991 exports of goods rose by some 7% while imports of goods declined by over 1% (in real terms). But given the anticipated fall in tourism activity the current account will not improve to the same extent as the trade balance.

Measured inflation (consumer prices) decelerated from 22,8% (year-on-year) in December to 18,4% in May. The authorities are confident that the current trend could lead to an inflation rate of close to 15% by the end of the year if no discretionary increases in indirect taxes are made, if exchange rate policy continues its present course and if the oil price remains stable. Apart from weak economic activity the restrictive incomes policy seems to have played a major role in bringing down the inflation rate. In the public sector nominal wages are advancing according to the announced policy (4% in January and another 4% in July). Taking into account the carry over from 1990 and the so-called maturity effect nominal wages are estimated to rise on average by 13,8% in 1991. In the private sector the collective agreements concluded for a period of two years incorporated wage increases of 15,2% for 1991. For the economy as a whole, the increase in nominal wages per head in 1991 is calculated at below 15%. This compares with an increase of over 21% in 1990. The impact of the restrictive wage policy on cost and price developments is also shown in calculations of the underlying rate of inflation. According to estimates by the Greek authorities in the period January-May the underlying rate (measured as CPI adjusted for increases in public tariffs and in the oil price) rose by a cumulative 5% compared to over 7% in the same period last year.

The weakening in economic activity and the restrictive fiscal policy is reflected in rising unemployment. Registered unemployed[1] rose dramatically since mid-1990 reaching some 179 000 in April 1991 from a low of 109 000 in May 1990. The unemployment rate as measured by the registered unemployed increased correspondingly from 5,3% to 8,2% in the same period. Should this trend be confirmed by the annual survey this would imply a sharp increase in the survey unemployment rate from its level in 1990 (7,5%).

Recent developments in the balance of payments are encouraging and prospects for the remainder of the year favourable. According to settlement statistics the trade balance in the first four months of 1991 showed an improvement as exports rose faster than imports. In the period January-April non-oil imports rose in Dollar terms by only 8% on

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(1) For a number of reasons registered unemployment is not representative of the level of unemployment but seems nevertheless to be a good indicator of short term trends. It should be recalled that according to the Labour Force Survey, which is carried out once a year in May/June, unemployment was 310 000 in 1990.

the same period last year; both weak domestic demand and some destocking seem to underlie this trend. Non-oil exports, on the other hand, rose in the first four months by 13% in Dollar terms over the same period 1990. The relatively good prospects on the oil markets is another factor contributing to the improvement in the trade balance. However, given the huge difference in level (import values are nearly three times as high as export values) the observed trend cannot prevent the trade deficit from widening in absolute terms. The balance of invisibles improved substantially, but this was to a large extent due to the near doubling of net transfers from the EEC. As a result, the current account deficit shrank from USD 2 502 million in the period January-April 1990 to USD 1 883 million in the same period of 1991. Private capital inflows in the four-months period were lower than in the same period last year reflecting a fall in foreign currency deposits while capital imported for investment purposes rose by 34%. Gross official borrowing from abroad nearly doubled compared with the first four months of 1990; net official borrowing from abroad amounted to USD 904 million against USD 1 116 million a year earlier. Foreign reserves stood at USD 3 754 million (compared to UDS 3 252 million a year earlier) at end April 1991.

Overall recent macroeconomic trends show that in 1991 a weakening economy will produce both lower than expected inflation and a better balance of payments performance. However, these gains could prove transitory and unsustainable if no successful effort is made to place them within a framework of healthy public finances on the one hand and the necesary restructuring to improve the output potential of the economy on the other.

III. PROGRAM DEVELOPMENTS

A. The Budget

The budgetary adjustment foreseen by the program requires a decline in the central government borrowing requirement from 17% of GDP in 1990 to no more than 10,4% in 1991; a containment of ordinary budget expenditure to an increase of 22,3% in nominal terms, or 4,4% in real terms, between 1990 and 1991; an increase in nominal ordinary budget revenues by 45,2% (of which an increase of 34,1% is projected for tax revenues while a rise from DRS 194 billion in 1990 to DRS 582 billion in 1991 is budgeted for non-tax revenues); and a commitment to widen the tax base and to take effective measures to combat tax evasion.

Trends in Tax Revenues

The trends in tax revenues suggest that the 1991 target will not be achieved. The target for the central government tax revenues is DRS 3 768 billion (including DRS 140 billion revenue of the investment budget), representing an increase of 35,2% over last year's tax yield. In the period January-May 1991 tax revenues have grown at a diminishing monthly rate, and in May 1991 they grew by 16,5% over May 1990. The increase in cumulative revenues up to May 1991 over the same period last year was 24,3%, clearly below the increase which would be necessary to secure achievement of the annual target. Table 1 presents some key data on the evolution of revenues so far this year and in

1990; only 34,8% of the budgeted 1991 tax revenues (31,2% of total revenues) has been attained by May. A somewhat less pessimistic

Table 1
Trends in Ordinary Budget Revenues in 1990 and 1991
(percent annual change and percent of budgeted revenues)

	1991/1990		1990/1989	
	% change	% budgeted	% change	% total
January	28,8	6,8	30,0	7,7
February	30,9	4,7	15,2	5,2
January/February	29,7	11,5	23,7	13,0
March	27,2	5,6	26,8	6,5
January/March	28,9	17,1	24,7	19,4
April	22,5	6,6	39,9	7,9
January/April	27,0	23,7	28,8	27,3
May	16,5	7,5	45,4	9,4
January/May	24,3	31,2	32,7	36,7

Source: Data supplied by the Ministry of Finance

picture emerges if revenues from special sources, which are expected to be collected in the second half of the year, are taken into account; these include DRS 150 billion from deposit interest taxes, and the Ministry of Finance expects another DRS 90 billion from unresolved tax cases and DRS 100 billion from past tax obligations. If these are excluded from the target tax revenue of DRS 3,768 billion, the required rate of growth to attain the new target (26,7%) is closer to the average growth of tax revenues recorded in the first five months of this year (24,3%). However, there is uncertainty about the feasibility of collecting the special revenues other than the deposit interest tax.

In addition, the slowdown in nominal output will be another factor restraining the growth of tax revenues. It is now evident that, compared to an initial estimate of nominal GDP growth of 18,2% for 1991, the decline in economic activity and the easing of inflationary pressures could reduce nominal GDP growth by over three percentage points below the initial estimate this year. With an estimated income elasticity of tax revenues of around 1,12, and with nominal GDP growth equal to 15% in 1991, tax revenues would be around 100 billion less than estimated on the basis of the original GDP assumption[2].

Data for the first quarter of 1991 show a small increase in direct tax revenues (3,8% over the first quarter of 1990). Personal income taxes

(2) This is a shock-control estimate, where the control is the simulated tax revenues on the basis of 18,2% nominal GDP growth, and the shock is the simulated tax revenues on the basis of 15% nominal GDP growth, in 1991.

have risen by 17,2%, probably below the rate of nominal GDP growth during this quarter. Other tax revenues, reflecting also the extraordinary levy imposed in 1990, are markedly down this quarter, and this has biased the recorded growth rate downwards. Indirect taxes were up 38,7%. Of the latter, tax revenues from imported goods suggest that Greece's import growth is weakening. The single most important increase relates to fuel tax revenues; these were up 129,2% in the first quarter. Excluding these, the growth rate of the remaining tax revenues is 22,4%, implying an overall elasticity in excess of unity. There has also been a 14,7% increase in non-tax revenues this quarter. The growth rate of total ordinary budget revenues was 28,9% in the first quarter, and 17,1% of budgeted revenues was attained.

The data also show that there has been a 49,8% increase in the collection of direct tax arrears, but there has also been a 48,7% decline in the collection of indirect tax arrears, in the first quarter. Overall, tax arrears collection in the first quarter of 1991 showed no growth relative to the first quarter of 1990; an estimated DRS 18,7 billion was collected, amounting to 9,2% of budgeted arrears to be collected this year.

The Problem of Tax Evasion

A central feature of the adjustment program is combatting tax evasion. Tax evasion has become an enormous problem for Greece's public finances; however, little effective action has been initiated in this area.

Revenues from combatting tax evasion were projected to amount to DRS 250 billion in 1991. More specifically, DRS 160 billion were to be collected from current tax evasion (DRS 70 billion from direct, and DRS 90 billion from indirect taxes); and DRS 90 billion were to be collected from unresolved tax cases (DRS 60 billion from direct, and DRS 30 billion from indirect, tax cases); in addition, DRS 203 billion was expected to be collected from tax arrears (DRS 133 billion from direct and DRS 70 billion from indirect taxes)[3].

The Ministry of Finance has taken a variety of measures to improve the effectiveness of the tax collection mechanism and to limit tax evasion and fraud. The cross-checking of VAT invoices has been intensified, while failure to fulfill one's tax obligations is now a criminal offence; in addition, the Ministry of Finance plans further computerization, and both the process of tax assessment and of tax collection have been reviewed with the objective of improving their effectiveness. All customs offices are now computerized and tax offices will also be equiped with computers within this year.

However, there are serious doubts about the effectiveness of these measures. First, the tax collection system is already overburdened and does not have the capacity to pursue tax evasion adequately,

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(3) In an estimate made available to the Commission services, revenue from collection of tax arrears has now been revised to DRS 116 billion (DRS 76 billion from direct and DRS 40 billion from indirect taxation).

particularly where this involves extensive bureaucratic procedures. Such procedures characterise Greece's approach to tax evasion and the system is overburdened with regulations which have not furthered the ultimate objectives of increasing the efficiency and equity of the tax system. Indeed, the increase in the number of administrative regulations and legislative measures is itself a reflection of the difficulties encountered in combatting tax evasion. It is likely that the point of diminishing returns with respect to such actions has already long been reached. Secondly, efforts to pursue tax offenders in the courts are not successful due to the very substantial delays in court procedures. The inability to process tax cases through the court system in an effective and timely manner render many of the government's measures difficult to evaluate. In particular, such delays raise the stock of unresolved tax disputes and increase the probability that ultimately the government will seek some form of compromise with offending taxpayers. In the event, it may be rational to evade taxes and resort to court if discovered.

Past experience shows that the increased resort to tax regulations will not be an effective means to combat tax evasion, and that the prospective revenues from combatting tax evasion and fraud will be substantially less than anticipated in the budget.

The Alternative Income Tax System

There is urgent need to widen Greece's tax base. With this in mind, it was proposed that an alternative tax system for the self-employed be instituted and would apply in 1991. It now appears that the authorities do not intend to implement an effective alternative tax system.

The self-employed (which represent around 35% of employment) including the professions, are the key category of income earners who systematically evade taxes. Recent data on annual incomes declared for tax purposes by economic groups (4) show that the annual average income declared by professionals is around 28% greater than that of wage and salary earners and that of industrialists and shopkeepers is around 35% lower than that of wage and salary earners. Even though these data are crude, they imply unreasonably low average monthly incomes for the groups other than wage and salary earners whose incomes are visible and more verifiable. In addition, the share of tax revenues from the liberal professions in total tax revenues has fallen from 12,4% in 1980 to a low of 8,9% in 1985, before recovering gradually to 10,4% in 1990. During this period the contribution of wage and salary earners to tax revenues has risen from 38,8% in 1980 to a peak of 48,2% in 1985, and declined to 42,4% in 1990. Despite the fact that these data cannot prove the extent of tax evasion, they are consistent with the possibility of substantial under-reporting of incomes by the group of liberal professions; they also indicate the extent of taxation of wage and salary earners compared to the self-employed.

(4) These data were made available by the Ministry of Finance.

In an effort to combat tax evasion the Ministry of Finance initially proposed an alternative tax system for doctors, and invited the professional association to discuss the plan. The association rejected the invitation and the proposals, and the Ministry retracted in favour of a system of objective indicators.

The method which the Ministry of Finance proposes to use to tax liberal professions involves Ministry-determined levels of incomes and tax liabilities, against which the taxpayer's tax declaration will be evaluated. In the event that differences between the two emerge, it is up to the taxpayer to contest the Ministry's assessment, and in any case, various penalties are to be imposed both for false statements and for failure to actually pay the Ministry-determined tax. The system would be applied initially to doctors and lawyers before it is extended to other professionals, and will encompass incomes earned from 1990 on. <u>However, the Ministerial decision required to apply the new system has not been made yet</u>. There are no estimates regarding the amount of revenue expected from this measure, although there have been some early estimates that the increase in tax revenue from all the liberal professions excluding doctors would amount to DRS 10 billion; this is clearly inadequate.

Although the Ministry's method, if applicable, would go some way towards bringing these professional groups into the tax system, it in no way constitutes an alternative tax system(5). An alternative tax system would be revenue-certain and would be characterized by simplicity; it would also give the option of paying a predetermined amount of taxes, or make a self-assessment and challenge the exogenously set tax liability. The system proposed by the Ministry of Finance is not consistent with these principles and there is clearly no intention to meet this loan condition this year. Furthermore, there are questions about the effectiveness of the proposed system. In order to increase tax revenues through this system it is necessary that all disputes are processed in a timely fashion and consistent with the sense of tax justice. As noted previously, Greece's court system has been unable to process pending tax cases efficiently, some of which date back to 1985 when a similar system was introduced and subsequently abandoned. It is possible that the proposed new system could raise the stock of tax disputes taken to court, without raising any revenue in the meantime. Delays in resolving these disputes simply raise the probability that the state will ultimately come to some compromise with the taxpayer, thus fostering the incentive to avoid taxes in the intevening years. Some measures to remove these distortions have been introduced recently; these, for example, require that as much as 80% of the disputed amounts be paid by the taxpayer.

<u>Taxation of Agriculture</u>

The legal framework for taxing agriculture is in place; however, due to the absence of effective application these provisions have been weakened over the years. Currently it is doubtful that farmers will be taxed on the scale required by the loan agreement, although there are some plans to broaden the tax base through more effective taxation of

(5) As required by the loan decision.

agricultural activities. These include a condition that farmers cultivating a certain acreage (2 000m^2) and receiving more than DRS 300 000 in VAT refunds must submit an income tax return.

The Ministry of Finance expects some substantial increases in tax revenues from farmers(6). Taxes raised from agriculture in 1990 amounted to DRS 844 million with 48,4 thousand farmers submitting a tax return; this year it is estimated that DRS 10 billion will be raised as a result of stricter application of existing laws.

The Role of International Assistance

The Greek government has agreed to seek assistance from international experts, and to utilize resources within the existing Community support framework, to improve the tax collection mechanism. As yet, however, these commitments have not been translated into concrete plans. The Greek government has agreed to set up a tax administration group, and to undertake discussions about computerization plans. These plans should be evaluated against the background of relatively unsuccessful progress in computerization so far. It appears that the impact of these measures on 1991 tax revenues will be small, but its longer-term impact could be important. There is clearly an urgent need to advance plans in connection with international tax assistance and to strengthen the effectiveness of computerization plans without delay.

Non-Tax Revenues

In the 1991 budget non-tax revenues were projected to increase sharply. The budgetary program estimated that non-tax revenues would amount to DRS 582 billion this year, representing 13,4% of total central government revenues, and 13,8% of ordinary budget revenues. Of these, DRS 300 billion is to be collected from the privatization of utilities (DRS 125 billion), from the sale of ailing enterprises (DRS 50 billion), and from the sale of land bonds (DRS 125 billion), while the remaining DRS 282 billion is recurrent revenues from various profitable state activities. Because of uncertainties surrounding the former category of revenues, there are serious doubts that the target for non-tax revenues will be achieved this year.

Net receipts from the sale of enterprises held by the Industrial Reconstruction Organization (IRO) are estimated at DRS 153 billion, of which the privatization of the Heracles Cement Works (HCW) is expected to yield around DRS 135 billion, in 1991. There has been considerable progress in preparing the privatization program and seven entities have already been sold out of a stock of 170 companies available for denationalization. However, the key transaction on which achievement of the non-tax revenue target for 1991 hinges is the sale of HCW. This is a profitable enterprise in the sale of which substantial purchasing interest has been expressed. The government anticipates to complete the sale of HCW in October/November 1991, thus meeting closely this

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(6) The share of tax revenues from farmers (around 10% of the population) in total tax revenues has been in the range of 0,2%, and in 1989 and 1990 it rose to 0,3%, according to data from the Ministry of Finance.

ccmponent of budgeted revenue. However, delays in the privatization process and various legal difficulties leave room for doubt as to whether the sale of HCW will take place within the current fiscal year.

There are suggestions of the possibility of selling shares in utilities this year. While it is technically possible to sell licenses for cellular telephony, there remain serious hurdles to be overcome and the possibility that this will be accomplished this year appears remote. A more realistic timetable for the sale of shares in utilities would be next year or 1993. Thus, there will be virtually no budgetary gains from these activities in 1991, although the longer-term potential revenue is substantial.

With respect to the sale of land bonds, prospects appear less than encouraging. There has been only very little preparatory work here, and the choice of lands which will be offered for sale has not been finalized. There also appear to be a variety of legal problems interfering with certain sites which could potentially be offered for sale, and neither the final determination of the relevant sites, nor the decision to actually sell them, have been made. The current state of affairs does not suggest any confidence in the achievement of the budgeted land bond revenues.

An Assessment of the Revenue Prospects

The principal conclusion from developments and prospects so far this year is that, with respect to 1991, the authorities are seriously behind target. It is likely that on the basis of the measures taken so far this year there will be a serious shortfall in budgetary revenues in 1991. The shortfall could exceed DRS 350 billion. Failure to comply with the ex ante target in 1991 implies that the budgetary disequilibrium will be so much worse next year, and the required adjustment effort so much greater. This is a serious risk to the whole adjustment effort which the Greek authorities must face.

Table 2 presents a possible outturn for total revenue in 1991. The budget 1991 data are those of the adjustment programme. In the table it is assumed that the decline in nominal GDP growth will reduce tax revenues by about DRS 100 billion. In addition, the budget estimates assumed that measures against tax evasion would yield DRS 250 billion and that over DRS 116 billion would be collected from arrears(7); in view of the record of achieving such revenues from evasion and arrears, it is unlikely that these revenue estimates will be achieved and in the table it is assumed that only DRS 150-250 billion will be raised from these sources. It is also assumed that land bonds will yield an amount of DRS 50 instead of DRS 125 estimated ex ante and that there will be a shortfall of DRS 25 billion in the estimate for privatization revenues, while the revenue of the investment budget is left unchanged. Taking these data into account, tax revenues between DRS 3 300-3 400 could be collected. As a result, the tax revenue shortfall could be DRS 200-300 billion, and a shortfall in the central

(7) See footnote on page 7.

Table 2
Budgeted and Alternative Revenue Performance in 1991
(in billions of drachmas)

	Budgeted 1991	Possible outturn
Ordinary Budget		
Tax Revenues	3 628	3 300 - 3 400
Land Bonds	125	50
Privatization	175	150
Other	142	142
Investment Budget	140	140
Total	4 210	3 782 - 3 882

government budget revenue (tax and non-tax) in the range of DRS 300-400 billion, could be expected in 1991. These estimates may be optimistic with respect to privatization and to the success of the anti-evasion efforts and collection of tax arrears. Should these turn out to be less successful, the revenue shortfall would be greater.

Trends in expenditure

Central government expenditure has been rising fast in the first four months of 1991 totalling DRS 2 150 billion (up 50% on the same period in 1990). However, the evaluation of this trend must take into account the fact that there was a high concentration of amortization payments in the early months of the year. Expenditure net of debt amortization has been rising in the period January-April by 17,8% compared to the same period in 1990 while the rate of growth provided for in the adjustment programme was 18% for the year as a whole. Current trends therefore seem to indicate that expenditure growth is under control and that there are no early signs of a deviation from targets. However, there are signs of pressures on expenditures and in a number of areas there is a significant possibility of overrun.

Debt service

There are a number of factors which would point to a debt service cost for 1991 higher than budgeted :

- given that about 33% of foreign debt is denominated in USD, the appreciation of the USD will undoubtedly lead to a higher Drachma cost for debt servicing; as the budget was based on an assumption of 165 DRS/USD, an exchange rate of 185 DRS/USD on average for 1991 (corresponding to the current exchange rate kept constant for the remainder of the year) would imply an additional expenditure of the order of DRS 30 billion.

- The taxation of interest income as from 1.1.1991 engendered a shift of financial savings from bank deposits and bank bonds to untaxed Treasury bills and bonds and led therefore to a decrease in bank deposits. This combined with the gradual reduction in the ratio of compulsory investment by commercial banks in government paper (from 40% to 35% on January 31 and further to 30% on July 1) led to a net redemption of public debt held by the banking system. The government had therefore to sell a relatively higher amount of paper to the private non-bank sector (this, however, at a higher marginal interest rate, the difference between the interest rate on 12-month Treasury bills sold to non-banks and that on 3-month Treasury bills held by the banks being 4-5 percentage points). The additional cost from this shift between instruments could amount to as much as DRS 10 billion in 1991.

- Because the issuing of 2- and 3-years Drachma bonds at interest rates of 24% p.a. could create adverse expectations with respect to the determination to achieve the disinflation targets the authorities have shifted the financing of the deficits from bonds to Treasury bills. Since the interest paid on Treasury bills occurs at issue, whereas that for bonds at 12-monthly intervals, there has been a forward shift in interest payments resulting from the switch to Treasury bill financing.

- Finally, to the extent that the budgetary targets for 1991 are not fully met, the net borrowing requirement will be higher than budgeted and so will be the debt service cost (an overshooting of targets by DRS 100 billion would give rise to additional interest payments of the order of DRS 10 billion).

<u>Wages and salaries</u>

The wage bill is the second largest expenditure component and is, like debt service, inelastic in the short run. Developments in this area are therefore crucial for the prospects for achieving the budgetary targets. In the period January-April 1991 wages and salaries rose by 20,7% on the same period of 1990. This rate of growth compares with the annual rate of 14,2% indicated in the adjustment programme. The figure for January-April 1991, however, has to be corrected for the fact that subsidies from the central government to public entities (essentially hospitals) destined to cover their wage bill (which are counted as being part of the central government's wage bill, although they are grants to those public entities) were disbursed in the early months of 1991 for the whole first half[8]. Allowing for this element would result in a rate of growth of wages and salaries for the first four months of 1991 on the same period of 1990 of 16,8%.

For the year as a whole, prospects concerning the evolution of the wage bill will mainly depend on the evolution of the stock of employees, given the 4 + 4% wage policy which is being strictly applied.

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(8) It should be noted that this practice of early disbursement of grants (new in 1991 !) is contrary to what would be expected in the context of an attempt to control public expenditure better and to minimize the risk of overruns later in the year.

With respect to employment in the central government recent developments and future prospects are most worrying. The whole issue seems to be highly sensitive and the political system is confronted with massive pressures, which - instead of being resisted - have given rise to disturbing developments.

A survey carried out in 1990 aimed at identifying departments with redundant personnel resulted in claims for some 72 000 additional staff (the stock at end 1990 was 272 000 employees in the central government). The government, however, has decided on a freeze on recruitment and the procedure for examining these needs was suspended for 1991 (and is likely to be suspended for 1992 as well).

This "freeze" of the normal recruitment procedure, however, did not mean that recruitment was actually stopped. For urgent and specific needs a procedure of derogation to the no-recruitment rule was set up. In 1990 an <u>administrative authorization</u> for some 26 000 recruitments was given by the responsible body (an Inter-Ministerial Committee on Recruitments, consisting of 5 Ministers) and another 10 000 such authorizations were granted in the first five months of 1991[9].

To become effective, the administrative authorization must be followed by a <u>financial authorization</u> issued by the Ministry of Finance. The number of such authorizations granted up to end May was in excess of 5 000.

<u>Actual recruitments</u> in the first quarter of 1991 show that total employment in the central government rose by 1 170 people, as 1 900 departures were more than offset by 3 070 recruitments. Contrary to the policy announced by the government of one recruitment for two departures[10], in the first quarter recruitments exceeded departures by over 60%. There is, however, a differentiation in the sub-aggregates : while in the civilian, permanent civil servants' segment the 1 to 2 rule was respected, recruitments of policemen on the one hand and of temporary employees on the other were roughly 6 times as high as departures in these segments. In addition to these 3 070 people recruited in the first quarter the government plans to recruit in the remainder of the year the following categories of civil servants :

- 2 317 policemen
- 2 366 Ministry of Finance (tax inspectors, computer specialists, clerical jobs)
- 2 050 Ministry of Interior (destined for prefectures)
- 3 000 teachers (in September).

All in all, the planned recruitments in 1991 could amount to as many as 13 000 which corresponds roughly to 2 recruitments for 1 departure for the central government as a whole.

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(9) In an attempt to centralise the responsibility and improve control over the recruitment policy the government recently decided to abolish this Committee and to transfer the decision-making to the Council of Ministers or to the Prime Minister depending on the urgency and/or the financial impact of the decision in question.

(10) here is no explanation from the Greek authorities of the difference between the one to two recruitment policy announced by the Minister of National Economy and the freeze on recruitment 'operated' by the Minister of the Presidency.

A new law on public administration provides for a change in the system of employing temporary staff. In an attempt to avoid misuses (repetitive prolonging of temporary contracts) the jobs created traditonally in ths summer months and concerning mainly (?) seasonal needs (e.g. firemen, tourism-related jobs, etc.) is as from this year put on an hourly basis. The limit for employment undeT this scheme was fixed at 880 hours per person per year. The total amount of manhours was fixed for 1991 at 18 million which is said to be 15% lower than in 1990. The equivalent of these limits is the employment of over 20 000 people for a period of close to 6 months. The budgetary cost of this scheme is set at 15% below that of last year.

In conclusion, the trend in actual recruitments is clearly exceeding the 1 to 2 rule announced by the government and, if continued, would give rise to doubts about the capacity to attain the target of reducing public employment, as laid down in the loan decision. Moreover, the existence of a large stock of "authorizations" represents severe pressures and the risk of those authorizations eventually leading to actual recruitments is serious. The possible expenditure overruns in this area are not easy to quantify at this stage given the lack of transparency regarding the volume, the timing and the form of recruitment. But it is certain that any lack of discipline this year will lead to overruns in expenditure the full impact of which will be felt in next year's budget.

Other expenditure

Expenditure other than for debt service and wages and salaries advanced in the period January-April 1991 by 6,7% compared with a budgeted annual rate of 14,6%. It can therefore be considered as well under control. It should not be overlooked, however, that pressures on the government budget for grants especially from the main social security funds will continue as long as their financial problems are not effectively tackled. Spending out of the investment budget was 22% lower in the first four months than in the same period of 1990 compared with a budgeted annual rise of 23,4%, but an acceleration of payments is expected for the rest of the year. Finally, as far as the contingency reserve is concerned from the available amount of DRS 50 billion some DRS 30 billion had been used up by the end of May[11].

Expenditure control

Although the authorities maintain that overall expenditure is well under control and that any deviation from budgetary targets in 1991 would stem from a shortfall in revenue, there seem to be several risks for the remainder of the year as identified above. In addition, there

(11) Legally the full DRS 200 billion of reserves remains in the budget and while the Greek authorities are confident of maintaining expenditure in 1991 within budget, other than for debt service and wages and salaries, there remains some ambiguity as to whether remaining within the budget refers to the legal budget, including DRS 200 billion reserves, or the budget with a DRS 50 billion reserves. In any event, reserves are described as being under pressure.

are significant weaknesses in budgetary practices with respect to the capacity to control expenditure :

a) Transfers of funds between appropriations are permitted and common. This means that savings in one budget item (chapter or line) can be transferred elsewhere and are therefore not effectively transformed into savings for the budget as a whole. Furthermore, because of this feature, monitoring of budget developments can be difficult.

b) The reserves are always spent and if savings in one budget item are transferred to the reserve account they are subsequently used to finance expenditures elsewhere. It appears that towards the end of each financial year the government decides on how to allocate any remaining reserves.

c) More serious is the institutional framework allowing the Minister of Finance/the government to authorise spending in excess of budgetary appropriations without prior parliamentary approval. The parliament normally gives its approval ex post together with the adoption of the budget for the following year.

d) The absence of effective control over expenditure is aggravated by the fact that the Bank of Greece is given a general authorization to finance to all payments on behalf of the government relating to both public debt service and wages and salaries.

e) In this context, a worrying feature of administrative practices in Greece is that recruitments for which appropriations are provided for in the budget are normally delayed. If the recruitments are finally made sometime in the second half of the year, the appropriations available appear to suffice for employing more people than if these appropriations had been used on an annual basis (i.e. more than initially planned or estimated on the basis of the annual cost of an additional employee). This, however, has an explosive impact on the wage bill of the following year because of the carry-over effect.

f) The lack of effective expenditure control is even more surprising in view of the existing administrative tools which could be usefully applied to this effect :

- quarterly decisions by the Ministry of Finance fixing for each department the percentage of the budget appropriation which may be used and monthly decisions fixing the corresponding cash limits (as indicated above, this tool was misused in the case of subsidies for salaries of hospitals in early 1991);

- a network of Ministry of Finance's own units in each ministry empowered to exert ex ante control of any expenditure;

- in view of possible overruns in certain expenditure items a Committee consisting of the Secretaries General of all ministries was set up in early June with the task of reviewing all elastic expenditure items and proposing possible cuts.

Prospects for expenditure and budget deficits in 1991

The conclusion from the analysis of expenditure trends and prospects in 1991 is that total expenditure will likely overshoot budgetary targets. Debt service is the category of expenditure where the most detailed estimates can be made. Taking the individual components together and in addition assuming that the deficit will exceed the target by some DRS 400 billion, the additional cost of debt servicing can be estimated at some DRS 100 billion. With respect to wages and salaries as noted above the possible expenditure overruns are not easy to quantify at this stage given the lack of transparency concerning recruitment. The serious risks here lie in the possibility of a part of the existing (and rising ?) stock of authorizations leading to a faster increase in staff numbers and also in the explosive effect of such an event on the wage bill of the following years.

The estimate of the likely shortfall in budget revenue combined with the identified elements of possible overruns on the expenditure side lead to the conclusion that the budgetary deficit in 1991 could exceed the programme targets by over DRS 400 billion. Lack of discipline and adverse developments could lead to even higher deficits if no corrective action is taken in the second half of the year.

Debt Consolidation

In April 1991 state guarantees which had fallen due by the end of 1990 and which were held by banks in their asset portfolios were consolidated. The guarantees applied principally to interest and capital arrears on the part of public enterprises and entities (PEs). The amount involved was DRS 625 billion (or almost 6% of 1990 GDP), while a further DRS 90 billicn of debt held by the Commercial Bank of Greece is to be consolidated as well. The consolidation took the form of a bond issue on the part of the central government of the amount of the guarantees, which effectively replaced the guaranteed debt in bank portfolios. The banks are required to hold the bonds for a minimum period of one year, after which they can trade them in the capital market. The bonds bear a 3-year grace period in the course of which interest is capitalized. The rate of interest at which the bonds are issued is 19%, the same yield as in Treasury bills held by banks in accordance with the compulsory financing requirements. At the end of the grace period a bond covering the capitalized amount of deferred interest will be issued, so that the Ministry of Finance will have to pay not only the accumulated interest but also the interest on this new bond. This prototype is expected to apply to other consolidation operations planned by the authorities.

Greece's consolidation operations have implications extending beyond the balance sheets of the institutions involved, and have probably been necessitated by the emerging fragility of the financial institutions holding the government-guaranteed liabilities. At the end of the grace period, the borrowing requirements of the central government will rise sharply to account for the servicing of the debt (consolidated amounts plus capitalized interest). Thus, if inadequate adjustment is achieved in the period 1991-1993, serious imbalances will re-emerge in 1994.

The 1991 Budget estimated that state guaranteed debt amounted to DRS 3 200 billion at the end of 1990. Over 20% of this has now been consolidated. In addition the government intends to consolidate unguaranteed debt amounting to DRS 326 billion held by the Agricultural Bank of Greece, and also unguaranteed debts of the agricultural co-ops of an as yet undetermined amount(12).

Behind the consolidation operation lies a very unclear situation with respect to the financial position of the public enterprises and entities (PEs), where neither the treatment of their assets and liabilities, nor their debt service payments is transparent in their accounts. The consolidation operation has not removed either the debts or their servicing from the accounts of the PEs but has simply led to a switch of their liabilities from the banks to the state. Provided that they had accounted properly for debt servicing in their accounts, there should be no change in the PSBR from this operation. However, because in practice they did not service these debts or intend to, it is not entirely clear how they accounted for them in their books. The Commission has requested a clear statement from the authorities of the impact of consolidation on the accounts of the PEs and its effect on the PSBR.

Another worrying feature of the lack of transparency in the accounts of the PEs is the large deviation between accruals and cash borrowing requirements which was particularly pronounced in 1990. Provisional data show an estimate for the adjusted accruals deficit of the PEs of DRS 259 billion, and a cash net borrowing of DRS 34 billion, leaving a large unexplained difference. It is possible that this reflects either unrealized expenditure or failure to pay bills planned on an accruals basis, or a combination of both. This is a worrying feature of recent developments. The lack of clear interpretation of such large accounting differences makes understanding and control of the financial activities of the PEs very difficult.

In addition to consolidation the government is planning to grant some degree of debt forgiveness, intended to clear up the accounts which have been subject to consolidation. IKA, the social security organization, had DRS 55 billion of interest arrears consolidated in the April operation. It is expected that this amount and DRS 125 billion of principal will be written off in the coming months. It is also estimated that DRS 122 billion of payments will fall due in 1991;

(12) Some estimates place the amount involved in the range of Drs 300 billion, but in a recent seminar the Minister of Agriculture hinted that as much as Drs 700 billion may be involved. The Greek authorities were unable to provide an estimate of the amount to be consolidated.

concerning these no policy decision has been made yet(13). These developments indicate the underlying weakness of the financial situation of the PEs.

It appears likely that further debt consolidation will need to be implemented in coming years. Not only interest arrears are continuing to accumulate, but also the financial position of the institutions involved may be precarious; at the same time, the accounting principles followed by Greece's PEs do not shed enough light on the underlying problems. The financial relations between the PEs, the banks and the government will not be clear until a serious attempt is made to adopt international accounting standards. At present, there are no such plans.

B. Public Enterprises and Entities

Recent financing developments

Data on the financing trends of public enterprises during the first four months of this year do not, in general, reveal divergencies from budgeted figures. This picture should, nevertheless, be treated with caution for various reasons. Firstly, the impact on the wage bill of the collective agreements signed recently will be felt mainly in the second half of the year. This will also be the case for the impact on the wage bill of any increase in PE personnel either of a permanent or temporary nature.

Available statistical data for the first quarter of this year as well as additional indications concerning developments in the coming months, suggest that a major area of concern regarding PEs will be the finances of the Workers' Social Insurance Fund (IKA). There has been a substantial shortfall of receipts from social security contributions, estimated at DRS 15 to 17 billion so far this year. This is mainly due to the failure to pay contributions in certain sectors, such as the hotel industry and air travel (Olympic Airways) (as a consequence of the Gulf crisis). Another contributor to this shortfall of revenue is the declining rate of economic activity and the rising unemployment rate. Current estimates of the size of this shortfall for the whole year are of the order of DRS 40 billion.

Modest to poor operating results of certain PEs during the first four months of the year, notably those of Olympic, do not seem to be reflected in their borrowing requirements. The reason for this is either because of a deceleration in their investment programme (for example the Public Power Corporation cut its investment programme by DRS 23 billion) or due to a slowdown in their expenses by simply not paying their contributions to the social security fund (Olympic) or bills to other public enterprises for services or products provided by the latter.

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(13) It should be noted that despite these operations IKA's deficit is expected to rise to DRS 83 billion in 1991, while NAT's uncovered but capitalized interest obligations will amount to DRS 36 billion, after a government contribution of DRS 30 billion.

This is of great concern given the existence of sizeable differences in the cash and accruals net borrowing requirement of PEs for 1990 as noted previously. Not only has this unexplained difference risen very sharply in 1990 but if it represents growing problems in meeting current payments it augers very badly for 1991.

Transparency

This unexplained difference together with the problems exposed by the consolidation operation indicate that the financial position of the PEs is unclear. Transparency does not appear to be increasing.

The cleaning up of the financial operations and financial position of the public enterprises and entities should be a task of high priority for the Greek authorities for reasons of transparency, financial discipline and monitoring capability. Such a cleaning up exercise would make possible a more accurate assessment of the implications of the financing practices of certain PEs (accumulated arrears) as well as of the recent consolidation exercise. It is essential to provide a full account of the pre-consolidation as well as the post-consolidation financial operations and their accounting treatment with respect to all parties involved (PEs, banks, state).

C. Structural reform

While the correction of fiscal imbalances is the core element of the adjustment programme, the economic programme of the government also includes measures of structural reform aimed at reducing market rigidities and distortions and at strengthening the growth potential of the economy. Against the background of a series of measures already adopted in the course of 1990, the loan conditions stipulate that "the Greek government undertakes to provide, in consultation with the Commission, by June 1991, a timetable for legislative action over the adjustment period, to include the main elements in the proposed reforms".

The contacts between the Greek authorities and the Commission services have revealed that this loan condition cannot be met in a formal sense. To this date no comprehensive plan has been presented by the authorities which would constitute the government programme, taking into account the interrelationships between various areas of reform and fixing the timetable for the implementation of the individual measures. This delay is to be regretted all the more so as - given the long time lags required before measures of structural reform can produce visible results - an early decision on and implementation of these measures is needed so as to improve the responsiveness of the economy and to reinforce the prospective recovery.

Deregulation in goods, labour and service markets

The measures taken in 1990 included the partial abolition of the existing price controls, the establishment of the legal framework for part-time work and the introduction of the fourth shift, the liberalization of shopping hours, the freeing of the management of the state-owned banks and the continuation in the deregulation of the domestic financial system. Currently, preparations are being made in three fields.

- **Deregulation of the oil markets**

In accordance with the loan conditions (cf. point 5) the government will proceed to the full liberalization of the oil markets by the end of 1991. The reform proposed will contain the following elements :

- liberalization of retail prices
- fixing the tax element of the retail price in absolute terms
- liberalization of imports

Three problem areas have been identified :

- competitiveness of the two state-owned refineries which have a monopoly on the domestic market;
- to ensure the supplying of remote areas (islands, mountainous regions, etc.) at reasonable prices to the consumer;
- to comply with the EEC requirements on minimum stock levels for security reasons.

Final decisions on these points have not yet been made but the legislative bill on oil market deregulation was announced for July. It is clear that a series of legal, administrative and technical problems will have to be solved before the liberalization process can be completed. It goes without saying that the relevant Community legislation has to be fully respected.

- **Deregulation of housing markets**

Against the background of a long tradition of rent controls and other regulatory practices the government started a process of gradual liberalization of the housing market. A bill was passed through parliament in June freeing the rents for as much as 40% of the housing market as from July 1. New buildings, buildings to be newly rented or those vacant for more than one year, houses or appartments with an objective value of over DRS 30 million or purchased with foreign currency and those with a surface over 120 m^2 will be no longer subject to rent controls. For the remaining 60% of the housing market rents will be increased by 12% as from July, 1 1991 and by another 8% as from July, 1 1992. The intention of the government is to proceed to further liberalization in two years time. As far as rent deregulation for buildings rented for professional use is concerned, a bill is being prepared which will be submitted to parliament in August.

- **Deregulation of financial markets and services**

Financial liberalisation is advancing at a satisfactory speed, taking into account the extensive array of regulations which characterise the Greek financial system and the constraints that the huge financing needs of the wider public sector put on the liberalisation process.

Deregulation of interest rates covers all deposit rates except a minimum rate on saving deposits which, nevertheless, account for two thirds of the overall bank deposits. Lending rates on 90% of bank credit to the private sector and to public enterprises are now market determined following the abolition of the regime of preferential rates for credits to public enterprises.

The real progress this development represents is mitigated by the fact that banks cannot freely dispose of more than 50% of their resources. This includes the compulsory investment of 35% of deposits in Treasury bills, the 10% allocated to financing of the handicraft sector and 8% of reserve requirements for monetary policy reasons. This situation significantly constrains banks' ability to manage their portfolios and puts them at a competitive disadvantage, compared to their Community counterparts.

An important aspect of the necessary reforms regarding financial markets and institutions is the adaption of the national legislation to Community directives in view of the unified European financial area of 1993. Draft legislation has already been prepared concerning banking and capital markets. With respect to banking draft legislation covers :

- the second banking directive
- the directive on solvency ratio for credit institutions
- the directive on own funds

Work on capital market regulation includes the adaption of five Council directives. It is expected that this draft legislation will become law before the end of this year.

<u>Tax and social security reform</u>

- Tax reform

The piecemeal approach followed in Greece's economic policy has been particularly pronounced in the field of taxation and has resulted in a non-transparent and inefficient tax system. Coping with the allocative distortions, the inequalities and the budgetary difficulties arising from the existing tax system and preparing for tax harmonization within the Community, were the two major driving forces behind the tax reform as it was announced in the loan programme.

The Greek authorities have recently indicated to the Commission services the main elements of the contemplated tax reform and the tentative timetable for its implementation. Two working groups were set up to deal with the modernisation of the so-called tax code (a compilation of information requirements for tax purposes applying to businesses and self-employed) and with the reform of the main individual taxes, respectively. The first working group will present its report by the end of June; after consultations with the professional organizations the new tax code is planned to be published in the form of a Presidential Decree in October. The report of the second working group will be issued by the end of August and - after consultations with the professional organizations - the changes are planned to become law in January 1992.

The main elements of the reform as indicated by the authorities concern the income tax and can be summarized as follows :

- unincorporated businesses will be treated as corporations for income tax purposes; the profits, adjusted for the remuneration of the owners, will be taxed at company level;

- tax liability will be calculated on the <u>net</u> income instead of being calculated as the difference between the tax liability corresponding to the gross income and the tax liability corresponding to the tax-free allowances;

- generous tax-free allowances for specific groups of income earners will be reduced and reshaped;

- the tax-free allowances on the basis of proof of spending will be abolished;

- the co-responsibility of buyers and sellers for failure to issue receipts is being contemplated;

- the objective criteria for inferred income from consumption spending and from property purchases will be revalued;

- tax controls on businesses will be extended to <u>all</u> enterprises on a simplified basis (instead of more extensive controls of a sample of 0,5% of the companies);

- liberal professions will not be subject to the "alternative income tax" but their income declarations will be checked by the tax authorities against pre-established "objective" income estimates.

An assessment of the planned reform of the tax system is not possible at this stage, because the reform proposals indicated so far :

- are not definitive as yet;
- concern exclusively the taxation of income;
- are not based on a convincing analysis and evaluation of the past experience;
- are not based on a thorough analysis of their likely economic impact.

The importance of an ex ante analysis of the possible economic effects of the tax reform can be demonstrated with reference to the incentives given by the tax system with respect to savings and investment. The reform of the scheme on investment incentives introduced in 1990 involved a shift of emphasis from grants to tax incentives. A change in the tax system will therefore have, ceteris paribus, a larger effect on investment decisions than under the previous scheme. The differential tax treatment of various forms of savings (i.e. interest income from government paper is tax-free whereas that from deposits and non-government bonds is not; the purchase of real estate is subject to a disclosure of funds-clause whereas the accumulation of savings in bank deposits is not) could create distortions in the allocation of capital. How will these possible effects on saving and investment be modified, reinforced or weakened by the contemplated changes in the way of calculating the tax liability, in the way of taxing unincorporated businesses and in the tax brackets ?

A preliminary conclusion is that the contemplated tax reform, to the extent that it is known at this stage, does not seem to satisfy the requirements of a thorough, comprehensive and rational reshaping of the existing tax framework.

- **Social security reform**

The state of preparations for the reform of the social security system is equally unsatisfactory. Following the introduction of the first reform bill in September 1990 the government had the intention to proceed soon with a second stage of reform. Irrespective of the commitment undertaken under the loan conditions to present the main elements of this second stage by the end of June, the authorities informed the Commission services that they were beginning immediately the process of social dialogue on the second stage and to this end a Scientific Committee was set up involving the social partners. This Committee will issue its report in October.

Moreover, it is by no means clear, how the government intends to tackle the most pressing and urgent financial problems of the social security, especially the public pension, system in the short run. The consolidation operation of last April concerned two overindebted social security funds (IKA and NAT) for a considerable amount (DRS 276 billion out of a total DRS 625 billion); despite the beneficial effects of this operation and of the proposed debt write-offs for the accounts of the social security funds in question, their current operating deficits do not show a declining trend as yet, as some of the emergency measures taken last September do not seem to be implemented fully or correctly and/or to yield the anticipated results. For example, the increase in the contribution rates, the measures against evasion, the measures to intensively collect arrears and those destined to limit misuses and cut unnecessary expenditure did not prevent IKA from projecting a net borrowing for the whole year 1991 double that budgeted. Especially in this area there seems to be a problem of <u>effective implementation</u> of the reform steps taken. This is all the more surprising and difficult to understand, as the political price in the form of social unrest and discontent has already been paid, so that one should expect that the government would now be interested in obtaining the financial benefits in return.

<u>Reducing the share of the wider public sector</u>

Little progress has been made so far also in the third of the areas of structural reform identified in the loan programme. The programme of denationalizations/privatizations was extended to include in addition to the ailing companies shares (up to 49%) in the public utilities. Besides the obvious contribution to be expected from privatization to the budgetary targets on the one hand and the target of reducing public employment by 10% over three years, on the other, the more indirect but no less important effect of the privatization would be the strengthening of the supply side of the economy (less state interference, direct productivity gains in the companies themselves through independent management, more competition, etc.).

As indicated above, administrative delays and legal obstacles have slowed down privatization of the ailing companies whereas the public utilities, as they suffer from various deficiencies, not least from a non-transparent accounting system, are not easy to sell without prior creation of the necessary regulatory framework and preparatory steps towards establishing the true picture of their financial position. Prospects in this area are therefore rather uncertain.

Capital liberalization

As from 6 May 1991 the Greek authorities removed the restrictions on the movement of capital and limitations on tourist allowance which were subject to a derogation under Articel 108 of the Treaty. These decisions, which were taken in compliance with the terms of the Community loan, led to the full liberalisation of the following :

- tourist expenditure
- the use of credit cards abroad
- the acquisition by residents of real estate abroad
- the acquisition by residents of foreign long-term securities.

Following these decisions of the Greek government, the Commission proceeded on 6 June 1991 to the abrogation of the above derogation in favour of Greece.

The above developments constitute an important step towards a higher degree of integration of Greece's financial system to the European financial area. Capital liberalization is also expected to increase the pressure for modernization and reform in the domestic financial and non-financial markets.

No adverse effects on the balance of payments have been noted so far following these capital liberalization measures. Their implications for capital flows will be determined more by macroeconomic and financial developments and less by the extent of the liberalization operation as such; no adverse effects are expected on the capital account provided that the commitment to sound macroeconomic and financial policies is credible. A stock adjustment effect is probable following residents' ability to buy foreign shares and long-term securities. This effect would be normally outweighted by the inflow of direct and portfolio investment capital as well as other short-term capial attracted by high interest rates, as has been evidenced from the experience of other Community countries during the period of capital liberalization.

Recent balance of payments data point to an upward trend in the inflow of direct investment capital. This development observed already in the rest of the Community now appears, with a considerable lag, in Greece and is mainly attributed to the Single Market effect. Among the positive signs should be also included the accelerated conversion into drachmas out of foreign currency deposits.

D. Monetary and exchange rate developments

A strategy of tight money is an important supporting factor for the successful implementation of the loan program and indispensible for the process of disinflation which is needed to bring Greece on a path of nominal convergence with the ERM. Inflation performance and the evolution of credit and monetary aggregates have been encouraging since the beginning of the year and the monetary targets of the program are likely to be achieved. In the January-April period in particular, the strong shift in private portfolios in favour of tax exempt public debt, has made monetary management relatively easy. This influence is, however, unlikely to persist to the same extent. In the absence of this extraordinary factor, any overshooting of the PSBR target, as set by the authorities, makes the task harder for the Bank of Greece and might jeopardize at a later stage its efforts to meet the monetary target set in the loan conditions.

Domestic credit expansion (DRS 251,0 billion) was considerably lower in the first four months of 1991 than in the corresponding period of 1990 (DRS 704,9 billion). This favourable development, which occurred in spite of the increase in net cash PSBR (DRS 665,7 billion as compared with DRS 642,7 billion in the previous year), has two sources : Firstly, the sharp rise in sales of public debt from DRS 147,7 billion to DRS 541.7 billion to the non-bank private sector; and secondly, to a lesser extent, the slow growth of bank lending to the private sector.

The introduction of a withholding tax on deposit interest led to a substantial and unexpected (in its strength) switch from deposits to Treasury bills and government bonds. In January to April 1991, sales of public sector bonds to resident non-banks rose sharply and exceeded their respective level of the same period of the previous year by DRS 394,0 billion, while at the same time private sector bank deposits fell by DRS 403,3 billion. This shift in portfolios towards public debt is unlikely to continue once the adjustment process to the discriminating tax treatment fades out. In addition, credit (and correspondingly aggregate money) expansion underestimates the amount of bank intermediation as repos in government papers are agreed between savers and banks. Savers receive remuneration in the way of untaxed capital gain and/or (also untaxed) interest on government debt. For banks this business opens repo refunding opportunities. At the same time, it reduces deposits and the corresponding compulsory Treasury bill holding.

The slow growth of domestic bank lending to the private sector reflects to a certain extent cyclical factors. On the other hand, financial repression is probably driving the private sector into direct foreign borrowing. Data are not yet available for this item as a whole, but the development of suppliers credit may illustrate its increasing importance. In 1990, suppliers credit jumped by DRS 320 billion to DRS 456 billion, and in the first four months of this year supplier credits amounted already to DRS 284 billion (60% of the total in 1990). In order to assess the likelihood to achieve the monetary targets of the programme, suppliers credit and other direct foreign borrowing by the private sector should be accounted for.

In the first five months of 1991, the external value of the drachma was determined by the strong appreciation of the USD, on the one hand, and, by a smaller rate of depreciation against the ERM currencies. Between December 1990 and May 1991 the DRS lost 20,7% against the USD, 5,2% against the DM and 5,9% against the ECU.

The 12-month rate of depreciation against the ECU has been easing from 12,4% in January to 10,5% in May, a rate well below the current respective differentials in consumer price inflation vis-à-vis the ERM average. Given that the policy is maintained during the remainder of the year, the rate of depreciation is likely to fall below the 10-11 percentage point inflation differential envisaged for the end of the year. This would make it possible to maintain the non-accommodating exchange rate policy contained in the loan programme and, at the same time, to improve (if only slowly) Greece's competitiveness as measured by relative unit labour costs, where the differential is expected to be in the narrower 8-9 percentage point range.

The reduction in compulsory bank financing

The target to reduce the compulsory bank financing of the Government's budget to 30% of bank deposits at the margin by 1 July will be met. It is even being considered by the Bank of Greece to progress faster than programmed on that subject. However, deposits have actually fallen on the shift of private portfolios to government debt and they are not expected to increase fast. The small weight of the margin implies that the financial repression, as measured by the share of obligatory Treasury bill holding in the total stock of deposits, is to change only very little.

ANNEX.-

Monitoring of the Public Entities and Enterprises

Assessment of the monitoring system

The Greek authorities have recently set up, in compliance with the terms of the Community loan, a system of monitoring and control of the operating results and the borrowing requirements of the PEs. This is a positive development although the monitoring capability of the system, in its present form, as well as its effectiveness as a control mechanism remain limited.

The technical part of the monitoring mechanism set up by the Greek authorities consists of a detailed system of accounts which aim to register, on a monthly basis, the actual cash flows by main category of transactions for each public enterprise and public entity and to compare their developments with the budgeted data. It aims to detect divergencies from the targets set, thus enabling corrective action if this is necessary.

The setting up of the cash flow accounts is a useful technical apparatus and should remain the core of the monitoring system. Its effectiveness for the purpose it is destined to serve would remain, nevertheless, limited unless it is completed and improved in four directions: towards improving its early detection capability, enhancing its informational content, strengthening the control aspect, providing for emergency plans in case of significant divergencies from targets.

a) The capability of early detection of divergencies in key variables from their targeted figures is an essential element of the monitoring system. The cash flow system, in its present form, essentially provides an ex-post measure of the financial developments. Although this function remains useful, the focus should, nevertheless, be shifted to an early incorporation of the implications of new relevant information (such as collective agreements, tariff policies, currency and interest rate developments, economic policy measures, etc.) into the system in the form of modifications of the cash flow projections. This would allow an early assessment of the size of the divergencies.

b) The informational content of the whole system would be considerably enhanced with the availability of information on the outstanding liabilities and of financial assets of the main PEs. The usefulness of such information is made evident by taking into account the high share of financial charges (amortization plus interest) in total payments appearing in the cash flow accounts, ranging from 23% for Olympic Airways, to 30% for the Public Power Corporation, and 50% for Aerospace. Basic information would