POLICY BRIEF

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Economic Survey of Greece, 2005

Summary

Recent and prospective growth performance is good. The Greek economy has continued to grow vigorously, buoyed especially by low nominal and real interest rates and an expansionary fiscal policy stance, largely reflecting public works in preparation for the Olympic Games in 2004. The outlook is for some slowing activity in the near term, triggered by fiscal consolidation, but a subsequent pick-up in growth thereafter. However, inflation is likely to remain above the euro-area average, to a certain extent eroding Greece's international competitiveness.

Fiscal consolidation is the main priority. The fiscal audit, performed by the new government in close collaboration with Eurostat has revealed a very loose fiscal policy since the late 1990s, culminating in a general government deficit of 6% of GDP in 2004. The government debt-to-GDP ratio has remained stubbornly above 100%, despite uninterrupted strong growth during the past eleven years. Reining in government deficits is of vital importance both to meet the fiscal objectives of EMU, and to prepare for demographically-related budget pressures that will start emerging in a decade's time. Moreover, sustained high public debt makes Greece relatively more vulnerable to changes in interest rates and market sentiment, while its servicing threatens to crowd out public spending in areas important for Greece's ambitions to reach income levels elsewhere in the EU.

Convergence with EU living standards is a major medium-term policy challenge. Further policy challenges arise from the government's objective to eliminate the gap in per capita incomes with the EU-15, which widened from the late 1970s to the mid-1990s, but

This Policy Brief presents the assessment and recommendations of the 2005 OECD Economic Survey of Greece. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

OECD Observer

has narrowed since. A decomposition exercise shows that most of the income gap reflects low labour productivity rather than low labour inputs. There is substantial scope for catching up with best practice in leading countries in a number of policy areas, including competition policy; liberalisation of product markets, especially telecommunications and energy; policies to foster entrepreneurship; and the implementation of a better corporate governance regime.

There is also scope for better labour inputs. Convergence with European Union member countries could also be accelerated by getting more people into work through higher flexibility in the wage bargaining system; lower non-wage labour costs, especially for the lower-skilled; less stringent employment protection provisions; enhanced labour mobility; and more effective active labour market policies. In addition, training and education could be upgraded to improve educational outcomes, ensure that school-leavers have useful skills, and to support life-long learning. This would make workers more productive and raise their employability at both ends of the age spectrum.

Increased labour market flexibility from immigration will help. The inflow of immigrants during the 1990s was large, raising the share of foreigners in the population to over 10% and increasing the labour force by between 5 and 10%. Given the rigidities of the formal labour market in Greece, the existence of a substantial informal sector with latent demand for low-paid labour allowed illegal immigrants to find jobs in large numbers even while structural unemployment among the Greek population remained stubbornly high. While highlighting the effect that the relatively high ratio of minimum to average wages can have in reducing employment opportunities for the low-skilled, immigration has reduced the economic cost of these restrictions by allowing at least some Greeks to move to higher level jobs, and by increasing output and profitability in a number of sectors. ■

How has Greece's economy developed and what are the main challenges?

Greek GDP is estimated to have grown by well above 4% in both 2003 and 2004, thus outperforming not only the European Union, but also the OECD average by a substantial margin for the fourth year running. A sharp decline in nominal and real interest rates that preceded entry into the euro area in January 2001 was amplified by financial market reform, and the subsequent investment boom resulted in a large rise in productivity. Private consumption has been supported by strongly-rising credit, from initially low levels. However, employment growth has been only moderate, and structural unemployment remains high. Most of the recent strength of activity has been concentrated in domestic demand, especially construction, and services, in part arising from Olympic Games preparations, and financed by deficit spending. The fiscal audit performed during 2004 revealed that the deficit-to-GDP ratio had been understated by about 2 percentage points since 1997, and the debt ratio by 6 to 8 percentage points. The revised deficit for 2004 was 6% of GDP. With the world economy expected to continue its recovery over the coming years, growth is likely to continue exceeding the EU average despite substantial fiscal consolidation. But with the Greek economy still operating above potential, the inflation gap *vis-à-vis* the euro area may not narrow enough to prevent a further erosion of competitiveness that could at some point lead to a significant weakening of growth.

The main immediate challenge for Greek economic policy is to pursue substantial budget consolidation for some years not only to meet the fiscal objectives of EMU, but more fundamentally to prepare for budget pressures that will start after 2015 as population ageing impacts on an actuarially unsound and largely unreformed public pension system and raises the cost of maintaining the public health system. Over the medium-term, the main policy challenge is to close the sizeable gap with average EU-15 living standards. Convergence will require high per-capita economic growth over a prolonged period, which will entail both ensuring sound macroeconomic policies and raising potential output growth. Short-run prospects for solid growth remain good, but they may weaken in future years. Hence sustaining robust growth over the longer term will necessitate structural reforms to product markets – and their effective implementation – as well as the mobilisation of the large unused potential of labour inputs, especially among women and the young, and substantial improvements in human capital. ■

How quickly should fiscal deficits and debt be reduced?

In the near and medium term, strong front-loaded fiscal consolidation needs to be pursued. Quite apart from the constraints imposed by euro-area membership, it is worrying that Greece has recently had one of the highest public debt and deficit positions among Member countries, despite also having one of the strongest real growth performances. *The growth of public spending needs to be reined back sharply this year, with further consolidation over the medium term, at least as fast as envisaged in the most recent Stability and Growth Programme (SGP).* The government has implemented measures aimed at reducing drastically the deficit in 2005 and has committed to bring the deficit below 3% of GDP through the 2006 Budget. OECD estimates suggest that further measures may be required to meet the 2006 target. The credibility of the consolidation effort, to a large extent, hinges on this target being achieved. The latest SGP foresees a further reduction in the cyclically-adjusted deficit of 0.5 percentage points in 2007, which would bring the actual deficit down to 2.2% of GDP. *Prima facie*, this may not be sufficient, given both the size of the imbalances and spending pressures that will emerge in a decade's time as the baby boomer generation starts to move into retirement. An appropriate goal beyond 2007 would be to move steadily towards budget balance, while assuring that the ratio of public debt to GDP is firmly on a declining trend. *A more vigilant control of primary spending is required, concentrating on areas such as the public wage-bill (which has risen particularly rapidly in recent years), health and education*.

Achieving debt reduction also requires dealing with off-budget transactions that create debt. Such transactions cumulated to some 11% of GDP over the 2001-2004 period, and slowed the pace of debt reduction, despite sizeable privatisation receipts. They still amounted to around 3% of GDP in 2004, and plans to reduce them gradually to 1% of GDP by end-2007 are commendable. They should be fully implemented and extended beyond 2007. The previous government's target of a 60% debt-to-GDP ratio (the Maastricht target) by 2010 has been tacitly abandoned, and the OECD estimates that it would not be reached before 2017 even if there were no further debt-creating transactions after 2007. If these were to continue on the same scale after 2007 as envisaged until then in the SGP, a primary budget surplus of some 4¼ per cent of GDP each year after 2007 would be required. By comparison, the primary balance over the 2001-2004 period averaged 1½ per cent of GDP.

Tax reform packages came into effect in 2003, 2004 and 2005, which lowered the tax burden on businesses and households, contained measures of tax simplification and reduced both compliance costs and the cost of tax administration. *Further tax reforms should nevertheless be planned. Many more stamp duties could be eliminated. Revenue losses from additional stamp duty abolition could be offset by an extension of VAT on house construction and by an ending of the preferential treatment of some products, professions and areas. Further reforms should aim at the elimination of the many remaining exemptions and deductions in corporate taxation, and removing the bias in the taxation system in favour of the self-employed. Moreover, the large number of earmarked "third-party taxes" continue to distort resource allocation, are inequitable and reduce budgetary transparency and thus should also be phased out. Social security charges for the self-employed should be proportional to their net earnings, while high contributions on dependent employees should be reduced to cut non-wage labour costs.* Further unfinished business includes the reform of the local tax system and the introduction of a coherent property tax system, with a prerequisite the implementation of a National Land Registry. Another area for tax reform would be to better design taxes to underpin policies directed towards environmentally sustainable economic development. ■

What measures are needed to make the health and pension systems sustainable?

The health care system is a key area for restraining medium-term spending pressures. Reforms aimed at decentralisation and re-organisation of managerial control in hospitals are commendable. Further reform plans address the chronic lack of funding for public hospitals, the dearth of an effective national primary health care and prevention system, and the shortage of specialised staff. *A clear timeframe for implementing these reforms, and monitoring their progress, is indispensable*.

Further reforms to the public pension system also need to be implemented. The Greek pension system is one of the most generous and inequitable in the OECD, because of high statutory replacement rates, easy eligibility criteria, and large differences in pension benefits between pension funds. Without reforms, age-related expenditures would have risen by as much as 12 percentage points to over 22% of GDP between now and 2050. The reform approved by Parliament in 2002 unifies the current highly fragmented system, and gradually aligns civil service pensions with those of the private sector. These reforms will begin to have a fiscal impact starting only in 2017. However, the expected long-term improvements in pension financing appear to be more than offset in the short and medium term by increased minimum pensions granted at the same time, which apply to as many as two-thirds of all retirees. In any case, the 2002 reforms will not by themselves prevent pension spending from rising steeply after the middle of the next decade. Although it is neither necessary nor desirable to implement new reforms with immediate effect, further reforms will need to be implemented eventually to ensure long-run fiscal sustainability. It is desirable that such reforms be discussed and legislated for in advance, so that the current generation of workers can adapt to them. *Reform in Greece should aim to link pensions to lifetime earnings, as is increasingly the case in other OECD countries. Consideration could be given to indexing pensions only to prices, and statutory replacement rates should be modified to avoid pensions higher than the last salary (for full-time work), unless last salary levels are well below average lifetime earnings. The high minimum pension should be replaced by a means-tested benefit scheme*. Although the normal retirement age is set at 65 for men in the main pension scheme, only around one in eight of them are still working at that age. Most of the early retirement occurs under disability schemes or under special provisions for people in "arduous" jobs, not always narrowly defined. *Early retirement for privileged groups should be scaled back; in particular, the eligibility criteria for disability pensions and the definition of categories of arduous work should be radically scaled down*. ■

What needs to be done to make the public sector more efficient?

Expenditure on public administration in Greece absorbs a much higher percentage of total government expenditures than in most other OECD countries, with no evidence that the quantity or quality of services delivered are superior. This suggests that important social, political and economic goals could be achieved with significantly fewer resources. A major deficiency in this area is the absence of a system of performance evaluation that would provide incentives for improved efficiency and accountability of public servants. It is thus commendable that the government introduced a new system of human resource management in 2004 aiming *inter alia* at enhanced evaluation procedures for civil servants and performance-based career development and remuneration. *Given the apparent gap between legislated reforms and their timely implementation in a number of areas, public administration reform should focus on ensuring that policies are fully and efficiently implemented once the legislation has been passed.*

An efficient public administration and a well-functioning legal system are crucial for the successful implementation of structural reforms once they are enacted. A recent Working Paper published by the European Central Bank, as well as anecdotal evidence, suggest that there is substantial over-staffing in areas of the Greek public sector, and – more importantly – misallocation of human resources; thus, the Greek public sector absorbs a much higher percentage of total government expenditures than most other OECD countries. In addition, poor administration, lack of accountability, political interference and corruption, especially in the past, seem to be key features which weaken public sector efficiency. A major difficulty in improving the public administration has been opposition by the public-sector trade union, which has sought to defend the vested interests of public sector employees, as revealed by frequent labour unrest that has frustrated reform efforts and led to high public wage increases in recent years. Hence, to strengthen public governance, it is necessary to continue efforts to build consensus for reform through the conduct of an open dialogue. ■

How can Greece catch up with EU living standards?

Long-term growth scenarios suggest that even under fairly optimistic assumptions, Greece might not reach full convergence with EU-15 per-capita incomes before 2030, absent the effective implementation of comprehensive structural reforms and the closure of the inflation gap *vis-à-vis* the euro area. Indeed, for most of the past 30 years, the level of Greek per capita income has hovered at under two thirds the EU-15 average, and the income gap actually widened between the late 1970s and the mid-1990s. Differences in hourly productivity levels explain most of the gap, so increasing productivity growth is a central challenge facing Greek economic policy. There is no gap in *total* labour utilisation *vis-à-vis* the EU, as low employment rates of youths, women and older workers are offset by long working hours for full-time employees, and low levels of part-time work. There is thus considerable scope for higher labour inputs, which would not only raise Greek income levels, but would also contribute substantially to sounder public finances, a more equitable income distribution and social cohesion. ■

What needs to be done to raise competitive pressures in the economy?

More intense competition in product markets is likely to promote a better allocation of resources across the economy and a better overall employment performance. Anti-trust legislation was reformed four years ago, but the Competition Committee's well-documented under-funding improved only recently, leaving Greece's enforcement effort among the lowest of OECD countries. *Hence, more political support of the Hellenic Competition Committee is needed to allow it a more proactive approach in establishing a "competition culture" and in improving the understanding by the public of the long-term beneficial effects of competition in terms of sustained growth of living standards and high employment. A new draft law (made public in mid-March 2005) corrects many of the shortcomings of previous legislation and significantly upgrades the Competition Committee*.

Substantial progress has been made in recent years in privatising a large number of state-owned enterprises, including in the network industries. The gains could have been larger still if the state had entirely given up the control of, and involvement in, the management of public utilities. While liberalisation of the telecommunications sector has progressed quite rapidly, the electricity sector continues to operate in an uncompetitive environment with the incumbent Public Power Corporation (PPC) dominating the electricity market and the State still owning 51% of PPC. A major disincentive to entry to the electricity market is the vertical integration of the PPC and the restricted access to low-cost fuel, and a price setting which does not yet entirely reflect the opportunity cost of additional electricity supply. *A complete privatisation of PPC should also be considered, once competitive conditions have been established in contestable segments. Given the barriers to entry, determined steps are needed towards enhancing the powers and responsibilities of the sector's regulator in order to ensure competitive access and tariff conditions*.

The government has also announced its intention to open up the gas market before the end of the derogation period in 2006. Commendable initiatives in this context include the establishment of regulatory responsibilities for the sector, and the requirement of account unbundling in gas activities. The Public Natural Gas Company (DEPA) has also submitted a proposal for third-party-access tariff structure that includes transparent transportation tariffs and non-discriminatory access at a reasonable cost. *To enhance competition in both the gas and electricity sectors, the government should do away with the practice of "most-favoured-customer" contracts between the incumbent companies in each sector, which discriminate against other customers*. Some steps have also been undertaken to increase competition at the refining level via a re-organisation of the oil products market in 2002, but there is no evidence so far that it has increased competition in the sector. In addition, the government introduced legislation in 2002 to open domestic sea transport to competition. This paves the way for a modernisation in the ferry sector, but effective implementation will be critical, and should be monitored. ■

What are the best reforms to promote entrepreneurship?

Paradoxically, Greece has both a high rate of self-employment and a low rate of firm creation, by international comparison. Registering and licensing a business in Greece is complex and very time consuming, possibly discouraging foreign investors and risking corruption. Considerable effort is given to alter the situation, and this has been set as a priority by the new government. *To promote a more dynamic private sector, the government should eliminate the remaining obstacles to entrepreneurial activity. Most importantly, bureaucratic requirements for start-ups need to be more decisively overhauled, and once overhauled, decisively implemented, to take full advantage of the high entrepreneurial potential in Greece*.

Access to finance seems more difficult than in most other EU member countries, in spite of recent financial market reforms. In part, this reflects banks' usual demand for collateral often worth substantially more than the amount they lend, to avoid recourse to time-consuming legal steps to recuperate assets from companies which have failed. *Accordingly, the speed and efficiency of the judicial system needs to be improved to strengthen contract enforcement. This should include a re-examination of the bankruptcy legislation with a view to facilitating loan recovery, which would also improve the efficiency of financial intermediation*. The reform of the bankruptcy legislation is being examined by a specially formed committee in the Ministry of Justice.

With most of the transformation of the financial sector now accomplished since the liberalisation of financial markets from the 1990s, the provisioning for non-performing loans and the adequacy of capital are the main challenges facing the sector, in particular in the event of a future economic slowdown. *Financial market discipline should be strengthened by increased disclosure of asset quality and other risk indicators, which until recently was less developed than in other OECD countries*. The government has enacted a corporate governance law which applies to all listed companies, including banks, and which came into effect in November 2002. Main features of the law are the definition of the duties of board of directors, the safeguarding of minority shareholders' rights, the definition of the role of internal auditors and the protection of shareholder rights. The law should introduce adequate corporate accountability and disclosure practices and prevent the corporate abuses that occurred under the previous regime. *To become effective, the new law needs to be implemented rapidly and vigorously. The corporate governance principles could be made more effective by making them part of the listing requirements on an apply or explain basis*. ■

How can labour inputs in the economy be boosted?

The Greek labour market is still characterised by high unemployment, particularly among young people and women, and long-term unemployment still accounts for more than 55% of the total. Policy changes in 2001 attempted to make regulations on employment protection legislation, overtime and part-time work more flexible, but their impact on employment promotion appears to have been limited so far. A new package of labour market reforms was introduced in 2004, which included: the reduction of non-wage costs for unemployed women with children; the conversion of unemployment benefits to employment subsidies for registered unemployed; the creation of part-time jobs in the public sector to offer social services; and increasing the rent subsidy for unemployed persons finding work away from their home town. *While these initiatives should have a positive impact on employment, further reforms will be necessary and should aim at: making more effective the possibility of opting out of sectoral or occupational collective bargaining agreements in areas of high unemployment; reducing non-wage labour costs, especially for minimum wage earners; ensuring no discrimination against part-time employment; reforming employment protection legislation further, in order to reduce uncertainty in hiring and firing decisions; eliminating impediments to labour mobility, for example through a reduction in property transfer taxes; and improving the job-matching efficiency of the public employment service. The social partners should be encouraged to increase employment of lower-skilled workers, by allowing the gap between minimum and average wage levels to widen in future wage negotiations*.

Though the level of educational attainment has improved considerably over the past 25 years, the stock of human capital in Greece is below the OECD average, and adapting the educational system better to the labour market needs is in any case indispensable for achieving improved labour market performance. For example, the transition of young people from initial education to working life in Greece remains very slow by international standards. *General education should provide flexibility in the acquisition of new skills, and employers' representatives should be consulted in the design of training programmes so that they do in fact lead to skills demanded in the labour market. Reforms to the educational system also need to raise the share of students completing upper secondary education.* Recent policy initiatives attempt to improve the link between education, initial vocational and continuing training, and labour market needs. They also aim at improving the quality of education through the commencement of teacher training programmes, the introduction of advanced technology in schools combating "digital illiteracy", and an increase in the number of faculties in secondary and tertiary education. *While these initiatives are commendable, concrete objectives should be set for their effective implementation.* ■

What role does migration play?

Greece has not yet found a way to bring immigration legislation into line with the facts on the ground. There are now large numbers of illegal immigrants more or less openly recruited on a highly flexible informal labour market and working at low wages, whereas the legislation admits low-skilled immigrants only under a cumbersome procedure. Illegal immigrants have helped to satisfy the latent demand for low-skill, low-wage labour that labour market practice and legislation had helped to create, while at the same time further encouraging the informal sector and segmenting the labour market. The regularisation exercises (of which the most recent has taken much longer than foreseen to complete) have reduced this segmentation somewhat, by allowing some immigrants to acquire legal status and labour market rights. At the same time, they may also have increased the attractiveness of Greece as a destination for illegal migrants.

The benefits of immigration are particularly clear in certain sectors, such as agriculture, construction and household services, where Greeks were unwilling to work for sufficiently low wages. To the extent that it is minimum wages and the social safety net that have created the labour market gaps filled by immigrants, some of the immediate gains to the Greek economy from immigration will be reduced if immigrants are subject to the same constraints and incentives as nationals. This may explain why the theoretically strong legislation against employment of illegal immigrants is rarely enforced. In the longer run, as even illegal immigrants become increasingly integrated into Greek society, it may be difficult to maintain the differential treatment of migrants and nationals in the labour market. The net effects of integration would nevertheless tend to be positive, especially if the need to increase employment is taken into account.

Measures to increase wage flexibility in the formal labour market, such as action on the cost of employing low-skilled workers or relaxed employment protection legislation, may be helpful. They would allow the economy to continue to benefit from the expansion of employment of Greeks as well as immigrants in sectors that have absorbed immigrants, encourage activity in these sectors to move from the informal to the formal sector, and also make it easier for low-skilled immigrants to work legally. The provision that household service workers and their employers pay only half of the minimum wage earners' social contributions is a good step in this direction. *Measures such as these may not make it any easier to develop immigration policy itself, though they might help to improve the information on which such a policy could be based. They might also allow immigration policy to be more transparent and easier to enforce, by reducing the size of the informal sector*. ■

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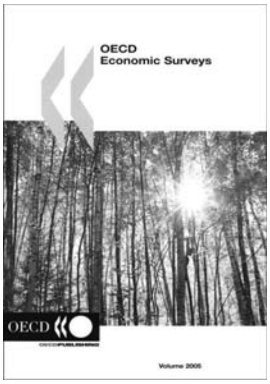

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- **Economic Outlook No. 77,** June 2005. More information about this publication can be found on the OECD's Web site at *www.oecd.org/eco/Economic_Outlook*.

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10 2005 12 1 P4

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