Policy Brief

February 2001

Economic Survey of Greece

Summary

Since the early 1990s, the Greek authorities have made great strides in bringing macroeconomic imbalances under control. The sustained effort has been crowned by Greece joining the euro area in 2001. While the growth and inflation performance has improved considerably, major policy challenges lie ahead. Furthermore, following this extraordinary effort, monetary policy had to ease in 2000 prior to joining EMU, thus fuelling demand. With rapid growth projected to continue in 2001 and 2002, underlying inflationary pressures could rise. Fiscal policy should thus tighten and tax cuts only be implemented if accompanied by spending cuts. There has been expenditure slippage in recent years, largely due to the failure to implement wide-ranging health, pension and administrative reforms. In all three areas deep reforms are needed not only to improve the efficiency of the public sector but also to keep a sufficient primary surplus to ensure a rapid reduction in debt. Structural reform has also been slow in many other areas. There has not yet been a comprehensive tax reform and, except for better tax compliance, the tax system has performed poorly in various respects. The authorities have indicated that a wide-ranging tax reform will be on the agenda in 2002. Various options to broaden tax bases and lower tax rates exist. Moreover, lowering non-wage labour cost by reducing social security contributions would improve job prospects. A step in this direction is included in the recent bill submitted to Parliament. Overall, labour market performance has been poor and labour market rigidities still need to be tackled. Concerning product markets, the privatisation

This Policy Brief presents the assessment and recommendations of the 2001 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 Deparment which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

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agenda has progressed and liberalisation of the telecommunications sector is largely a success. On the other hand, liberalisation of the energy sector and the restructuring of ailing enterprises should have progressed more rapidly and competition policy needs stronger teeth. Additional structural reforms, together with continued macroeconomic discipline, would raise potential output growth further and support a more rapid convergence of per-capita incomes to the level of other EU countries. ■

How did Greece meet the EMU challenge?

Over the last decade, the macroeconomic fundamentals of the Greek economy have improved remarkably. In the first half of the 1990s, growth had been among the lowest in the OECD and living standards fell relative to the OECD average. Activity was hampered by rampant inflation, fed by the largest government deficit in the OECD area and by serious structural problems in many sectors of the economy. With policy makers setting their sight on entering monetary union, a substantial policy effort has been sustained over several years and the large macroeconomic imbalances have been brought under control. This has boosted the overall performance of the economy and the goal of joining the European Economic and Monetary Union (EMU) as of January 2001 has been achieved.

Output growth has outstripped the euro area average since 1996. Despite the slowdown in export market growth in 1999, activity did not decelerate and is likely to expand by 4 per cent in 2000, due to strong growth of investment and exports. Meanwhile, despite the waning effects of the car sales tax cuts, moderate wage settlements, and higher oil prices, other factors such as the autumn 1999 tax and benefit package and lower interest rates have resulted again in brisk private consumption. Strong growth during 2000 should allow some decline in the high unemployment rate to 11½ per cent. Headline inflation reached a low point in September 1999, when consumer price index (CPI) inflation fell to 2 per cent. Since then, inflation has moved up to close to 4 per cent, because of the decline in the effective exchange rate and soaring oil prices. Underlying inflation has remained subdued so far, even though it has drifted up in recent months to 2.7 per cent in October 2000.

Short-term growth prospects are very favourable. Exports should remain buoyant, because of strong market growth and gains in competitiveness. And domestic demand should remain strong. Household consumption should be boosted by job creation, low interest rates and brimming consumer confidence that should outweigh the negative effects of the oil price hike. Capital spending is also likely to rise substantially. Hence, output growth could be around 4½ per cent in 2001, the strongest rise in a decade, before edging down but remaining above 4 per cent in 2002. This should allow a decline in the unemployment rate to 10 per cent in 2002. Headline inflation is projected to peak at the end of 2000, but could remain close to 2¾ per cent in 2001 due to carry-over and the waning price level effects of the indirect tax cuts that have helped to ensure the Maastricht inflation criterion. Inflation may recede somewhat in 2002. However, underlying inflation is likely to drift up further over the projection period. ■

Can inflation be kept under control?

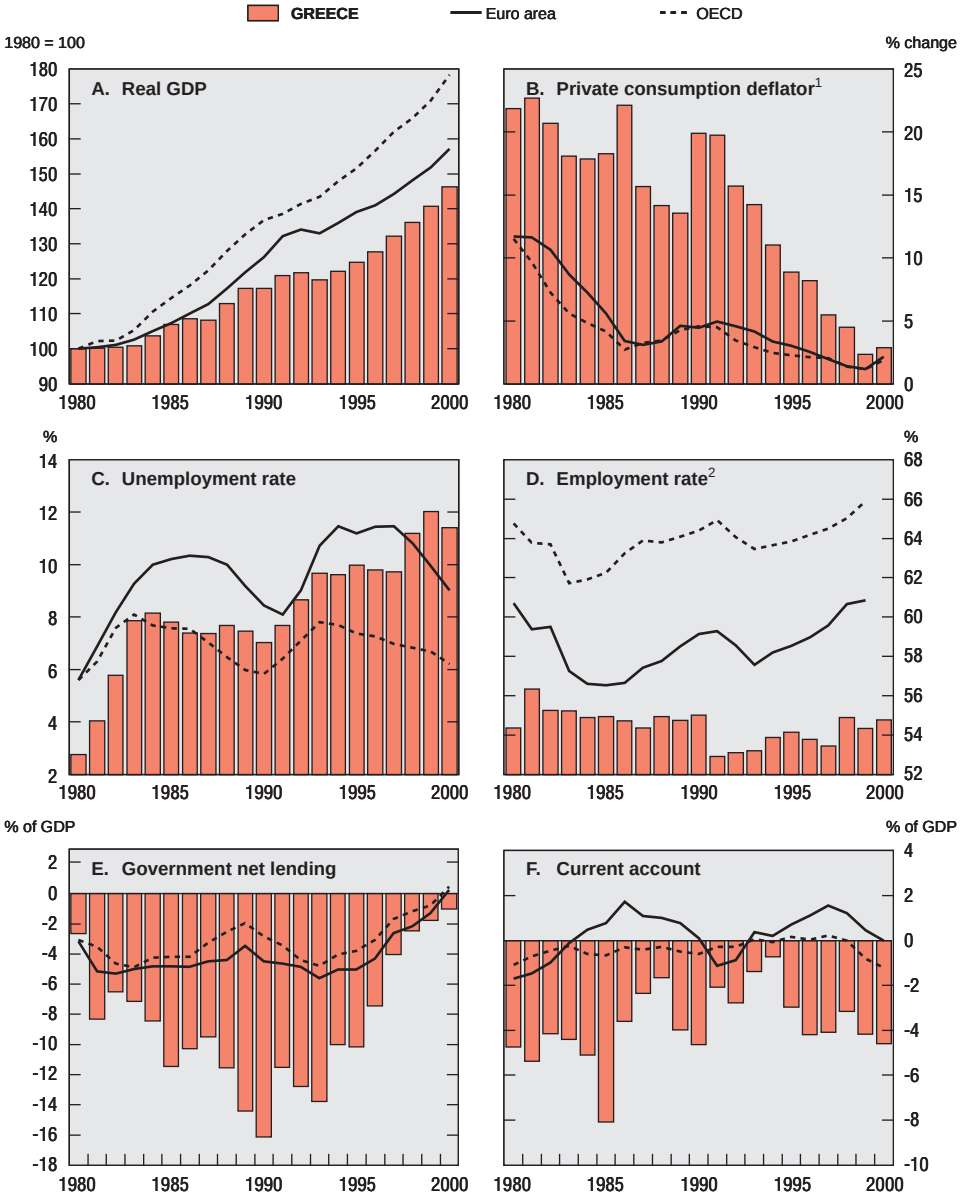
In recent years, the disinflation process has been largely shaped by tight macroeconomic policies and by incomes policies geared to ensuring wage moderation. Looking ahead, however, these factors may operate differently:

First, while the two-year wage agreement of May 2000 again implies another moderate central wage increase, it does include a catch-up clause for 2002, if average inflation is higher than anticipated in 2001. Moreover, wage drift has become sizeable in some fast-growing sectors.

Second, fiscal policy was restrictive until 1999, but then shifted into neutral gear in 2000. The fiscal stance is likely to remain broadly neutral in 2001 and 2002, even though strong growth should ensure a further significant improvement in the budget balance.

Third, while the hard drachma policy and the maintenance of high interest rates in recent years were clearly instrumental in taming inflationary pressures, monetary policy has eased substantially. The Bank of Greece started to relax monetary policy already in Autumn 1999. Since then, the key policy rate has declined from 12.0 to 6.5 per cent in November 2000, the exchange rate has moved down to the central rate and the long-term interest rate

Key indicators in long-term and international perspective



1. OECD excludes high inflation countries.
2. Total employment as a per cent of working-age population (aged 16-64).

Source: OECD.

differential *vis-à-vis* the euro area average has become small. Monetary policy has eased further before January 2001, as the short-term interest rate had to decline by around another 175 basis points prior to joining the euro area. Moreover, liquidity of the banking system will rise between January 2001 and July 2002, when the Bank of Greece will gradually release banks' required reserve holdings that are in excess of their current reserve requirements, following the reduction in the ratio from 12 to 2 per cent as from July 2000.

The short-run effect of the monetary policy easing could be smaller than in Ireland, Portugal or Spain prior to joining the EMU, because Greek households are large net creditors. But with indebtedness low and financial markets evolving quickly, there is considerable room for leverage for both households and enterprises. Demand could thus receive a sizeable boost over an extended period. The relatively rapid expansion of credit, which is currently running at a rate close to 17 per cent, the upward drift in underlying inflation and a widening current account deficit highlight overheating risks. ■

Should fiscal policy be tightened?

The OECD's assessment is that the fiscal stance has become neutral in 2000, with faster than expected revenue growth offsetting the 1999 tax and benefit package and slippage on the expenditure side. The 2001 draft budget again includes tax cuts. The proposed tax measures amount to ½ per cent of gross domestic product (GDP) and further tax reductions have been announced for 2002. Despite the tax package, the budget balance is projected to improve through 2002 due to cyclical gains and flat interest payments with the structural primary balance suggesting that the fiscal stance will remain broadly neutral. However, in the context of continuing strong momentum, fiscal policy should tighten to stem overheating risks. Moreover, the temptation to use revenue windfalls for additional spending should be resisted and further tax cuts should only be contemplated if accompanied by spending cuts. The primary surplus of 6 per cent of GDP is already very high. However, a move towards a larger primary surplus would allow a more rapid reduction of public debt, which is still above 100 per cent of GDP. It would thereby provide greater scope for fiscal easing during cyclical downturns and ensure a lower country risk premium. The government's projections paint a more optimistic outlook with a target of a small general government surplus in 2001 rising to 1½ per cent of GDP in 2002. At close to 5 per cent, GDP growth is above the OECD estimates, while inflation is somewhat lower at the end of the projection period, reflecting an even more favourable assessment of the growth of potential output. In such a scenario, the slightly restrictive fiscal stance, as embedded in the official projections, would appear appropriate. The acceleration in potential output underlying the government's assessment is very rapid, however, reflecting a more optimistic view of future employment and productivity growth. A more cautious view, such as that underlying the OECD's projections, might provide a better basis for setting fiscal policy in the coming years. ■

Health and pensions: how can spending pressures be reduced?

Over the longer term, severe spending pressures are building up and maintaining a sizeable primary surplus will be a challenge. In order to contain spending pressures over the medium term deep pension, health and public management reforms would need to be implemented quickly.

Pensions. While the 1992 and 1998 reforms have ensured the viability of the pension system until 2005, they have not tackled its long-term financial sustainability. Adverse demographics, a low effective retirement age and benefits that are generous compared to contributions imply that, in the absence of deep pension reform, a substantial hike in the tax burden will be needed to cover future pension expenditure; the integration of economic immigrants into the social security system, as well as employment gains, will offset part of the effect of adverse demographics in the short term. The government has commissioned a wide-ranging study that will assess various options in this area to ensure the long-term viability of the system. Concrete measures could be in place by September 2001.

Health. Reforms in the health sector have progressed only a little: virtually none of the measures of the 1997 health reform bill is effectively in place, other than a few pilot projects concerning primary care. The government is now committed to take up again hospital management reforms and improvements in

primary care. Moreover, a single Unified Health Fund is to be created to promote a more uniform provision of health care and establish better control over costs. The latter is urgently needed as sizeable cost overruns have occurred in recent years.

Public management. The management of the public administration needs to be urgently improved: human resource management is indeed rigid, as is remuneration, and service is often poor, leading to high transaction costs. The government has acknowledged the need to upgrade public services. ■

Has the labour market become more flexible?

Measures to tackle the existing labour market rigidities and to raise the low employment rate would help to reduce overheating risks. The government, following a social dialogue on labour market reform, has submitted a draft bill to parliament. The proposals to lower employment protection legislation (EPL) somewhat and tackle the few remaining impediments to part-time employment are steps in the right direction. However, the government has also proposed to raise the mandatory premium for overtime work. Alternatively, the government proposal allows for the annualisation of working time, if the employer and employees agree, while at the same time cutting the effective average work week from 40 to 38 hours. This approach would tend to raise labour cost and could reduce labour supply, if not offset by additional hirings and the other labour market measures. Concerning the other key rigidities, EPL will remain fairly restrictive mainly in the broader public sector and for white-collar workers. The recent government proposal is, however, a step in the right direction. The minimum wage is likely to constitute a barrier to labour market entry for young people and women, unemployment of both being especially high. This is why employment subsidy programmes and proposed cuts in employers' social security contributions rates target both of these groups, thus lowering the labour cost to the employer. From 2000 onwards, the government is paying a part of employee contributions to the social security system for minimum wage earners. This measure is largely redistributive, but it will stimulate labour supply and also improve incentives to work in the formal economy. The same is true for the "making work pay" proposals concerning part-time employment. To some extent, labour market rigidities can also be addressed by active labour market policies (ALMPs). In the context of the National Action Plan, the government has started to upgrade the public employment service (PES) and a large number of Employment Promotion Centres (EPCs) are now in place. Moreover, the activation rate has increased, though it still falls short of the 20 per cent target. The effectiveness of the new set-up should be closely monitored. Overall, government actions and proposals go some way to improving labour market performance, but the still high structural unemployment and low participation rate imply that efforts in this direction need to continue. ■

Can privatisation and competition policy foster growth?

Product market reforms are required to foster strong medium-term growth and, thus, a more rapid reduction in the still sizeable productivity gap with the other EU countries. Greece has made quite some progress in privatising the large number of state-owned enterprises. While slowing in 2000, new legislation has been introduced to facilitate and speed up privatisations and a new privatisation plan for 2001 has been drawn up. To complete the privatisation agenda, the restructuring of ailing enterprises will need to be accelerated. Taking a broader view of the operation of product markets, competition policy has been relatively ineffective so far, due to staff shortages at the competition authority and the large number of small mergers that have had to be vetted. The size threshold for the investigation of mergers has been raised recently, which will ease this problem. The competition authority should now focus closely on horizontal issues and on establishing close links with the sector regulators in telecommunications and electricity. It should also seek a role in the privatisation process to ensure that appropriate competition-enhancing is made prior to each sale. At the same time, the large amount of subsidisation for industry and agriculture, which are largely co-financed with EU funds, should be scrutinised. In particular, the large national subsidies to agriculture should be lowered and better geared towards releasing resources from the low-productivity agricultural sector.

The liberalisation of the telecommunications sector has progressed well. The privatisation limit for the public operator has been lifted and the telecommunications sector is fully open to competition since early 2001. Liberalisation has led to a steep decline in telephone charges. Much less progress has been made in freeing up the energy sector, although the electricity sector will be partly liberalised as of February 2001. While Greek legislation has been brought into line with the relevant EU directives, competitive pressures are likely to remain low in the electricity sector. For geographic and technical reasons, foreign competition is virtually ruled out over the medium term and domestic competition is unlikely because of the public monopoly's access to cheap lignite. To foster competition, the public operator should be split into a network company and several independently-owned competing generating companies, and full privatisation of the company should be on the agenda. In addition, despite the derogation from the EU directives until 2006, liberalisation of the gas market should be speeded up. Regarding the water industry, a regulatory framework should be established prior to the full privatisation of the water companies and water pricing should be brought closer to social cost.

The financial markets have changed rapidly. Restructuring and consolidation of private banks has reduced cost, even though overstaffing due to the strict EPL is still of concern. The restructuring of the state-controlled commercial banks has also progressed. In the current environment of fierce competition and rapid credit growth, supervision of banking has been stepped up. There remains scope, however, to improve the frequency of reporting and the quality of disclosed information, especially concerning investments in the transition economies in the Balkans. ■

What are the options for a comprehensive tax reform?

A comprehensive tax reform is also needed to support strong trend growth. In this respect, the government has indicated that it plans to introduce wide-ranging measures in 2002 and this *Survey* reviews tax policy issues. Over the years, numerous tax changes have been implemented in a piecemeal fashion, leading to a complex and non-transparent tax system. As a result, the tax system has performed poorly. However, the introduction of VAT brought a major improvement to the tax system and successful steps in recent years to raise tax compliance have been reflected in strong revenue growth. The government should build on this progress and pursue its current efforts vigorously. In this context, bank secrecy should be lifted for tax purposes, and the practice of offering periodic tax amnesties abandoned. Moreover, the large number of third-party taxes should be registered, re-assessed and eventually phased out.

Though the Greek tax burden is not very high by international comparison, its distribution is very uneven. Revenue from the personal income tax (PIT) is low relative to other countries, while social security contribution rates are very high. Moreover, taxation of the self-employed is low, which partly explains the very high number of self-employed in Greece. There are numerous options to widen the various tax bases and reduce the higher and more distortive tax rates.

The taxation of the various forms of income from financial capital is uneven and distorts saving decisions. The overall tax rate on income from financial capital should be equalised, while the current practice of using easy-to-administer withholding taxes should probably be continued.

The use of the presumptive criteria system for assessing the self-employed has meant that they have paid little tax. Reliable bookkeeping appears to be a *sine qua non* for a more accurate income assessment and auditing.

Concerning the PIT base, the generosity of tax breaks, including owner-occupied housing, should be reconsidered.

A base broadening of this sort would allow a reduction in the strong progressivity of the PIT, which in turn would help to reduce incentives for tax evasion. It would also allow a reduction in the high social security rates paid on labour income that are likely to have adverse labour-demand effects and provide incentives to work in the underground economy.

There is also a wide range of tax incentives for the business sector that should be re-assessed and streamlined. Such incentives complicate tax administration and increase compliance costs. Moreover, they are difficult to target, which can lead to a waste of resources, while an inadequate dosage may be ineffective. Tax incen-

tives should only be provided in the few areas where market failures are likely to exist. Additional revenues from base broadening could be used to harmonise the corporate income tax (CIT) rate at a single relatively low rate. This would eliminate the current bias in favour of unincorporated businesses. Concerning tax incentives, the special regimes for shipping and offshore companies are currently reviewed in the context of the OECD initiative on harmful tax practices.

The taxation of environmental pollutants should provide the right signals for abatement. In this respect, the taxation of lignite, a major input into electricity production, should be raised. Such a move should be accompanied by a wider reflection on the use of taxes to reduce greenhouse gas emissions and pollution more generally. For instance, water charges should reflect environmental pressures and scarcity, and provide the right incentives for industry and agriculture to use water efficiently. The taxation of property should also be overhauled. In particular, the implementation of the National Land Registry should be accelerated. This would provide for a more accurate basis for assessing property. Greater flexibility in setting property taxes could be given to local governments, such taxes being their main revenue source. This would narrow the gap between their revenue-raising and spending powers and allow subnational governments to become more accountable and responsive to voters. ■

For further information

Further information on the Survey can be obtained from Peter Hoeller (email: *peter.hoeller@oecd.org*, tel.: 33-1-45.24.87.82).

For further reading

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- **Economic Outlook No. 68**, December 2000. A preliminary edition is published on the OECD Web site approximately one month prior to the publication of the book: *www.oecd.org/eco/out/Eo.htm*.

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