The Case for Making the Greek Budget More Growth Friendly

By Poul M. Thomsen

The overriding objective of the IMF's engagement with Greece is to help the country put itself back on a path of sustainable growth that benefits the Greek people. In this regard, we think that the current structure of the Greek budget is a serious constraint on growth. Below we provide a more detailed explanation of why the Greek budget in its current form is growth unfriendly, and why solving this problem requires tax and pension reforms.

In an effort to boost revenues, Greece has followed a policy of repeatedly hiking already high tax rates, instead of broadening the tax base. It has not worked. After years of this policy, Greece faced increasing resistance by taxpayers in 2014, which prompted the authorities to resort to installment and deferral schemes, even though the pervasive use of such schemes—Greece had a staggering 50 of them in the area of social security alone since 2001—means that they are inevitably seen by taxpayers as entailing de facto tax forgiveness. This is evident in the accumulating tax and social security debt to the state, which has reached €120 billion (around 70 percent of GDP, with half of taxpayers behind on their payments, Chart 1) and steadily declining tax collections, despite the extraordinary assistance provided to Greece by international bodies aimed at improving tax administration (Chart 2).

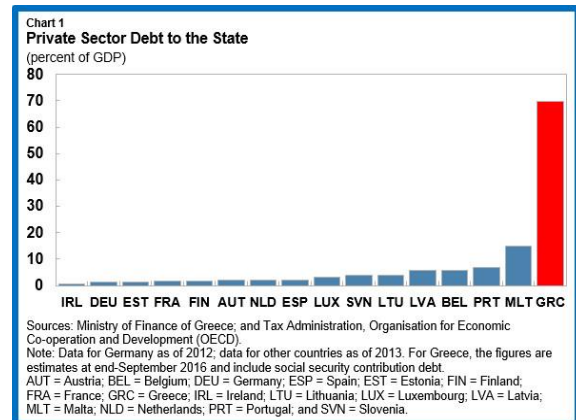


Chart 1
Private Sector Debt to the State

Sources: Ministry of Finance of Greece; and Tax Administration, Organisation for Economic Co-operation and Development (OECD).
Note: Data for Germany as of 2012; data for other countries as of 2013. For Greece, the figures are estimates at end-September 2016 and include social security contribution debt.
AUT = Austria; BEL = Belgium; DEU = Germany; ESP = Spain; EST = Estonia; FIN = Finland; FRA = France; GRC = Greece; IRL = Ireland; LTU = Lithuania; LUX = Luxembourg; LVA = Latvia; MLT = Malta; NLD = Netherlands; PRT = Portugal; and SVN = Slovenia.

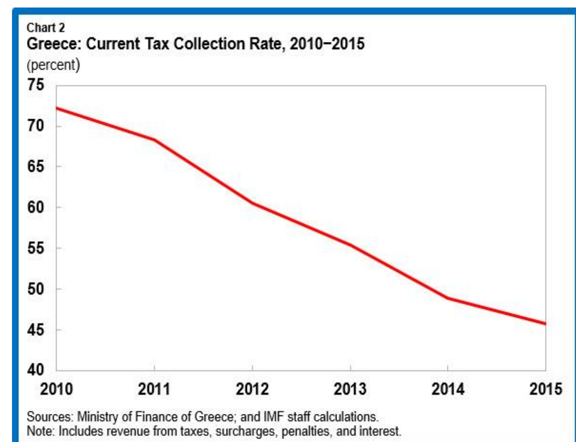


Chart 2
Greece: Current Tax Collection Rate, 2010–2015

Sources: Ministry of Finance of Greece; and IMF staff calculations.
Note: Includes revenue from taxes, surcharges, penalties, and interest.

Why do we argue that the tax base is too narrow? The income tax regime is a case in point. Greece provides an extremely generous tax credit, which allows more than half of wage earners to be exempt from income taxes (Chart 3). In Ireland and Portugal, by contrast, only 5 and 6 percent

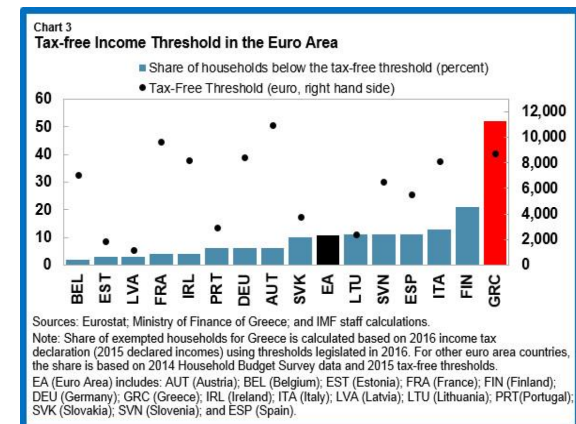


Chart 3
Tax-free Income Threshold in the Euro Area

Sources: Eurostat; Ministry of Finance of Greece; and IMF staff calculations.
Note: Share of exempted households for Greece is calculated based on 2016 income tax declaration (2015 declared incomes) using thresholds legislated in 2016. For other euro area countries, the share is based on 2014 Household Budget Survey data and 2015 tax-free thresholds.
EA (Euro Area) includes: AUT (Austria); BEL (Belgium); EST (Estonia); FRA (France); FIN (Finland); DEU (Germany); GRC (Greece); IRL (Ireland); ITA (Italy); LVA (Latvia); LTU (Lithuania); PRT(Portugal); SVK (Slovakia); SVN (Slovenia); and ESP (Spain).

of the base is exempt, respectively (the average for the rest of the Euro Zone is around 8 percent). In nominal terms, Greece's tax-free threshold of €8,750 is among the highest in the Euro area, higher than in Germany, Italy, or Spain. This also implies that the burden of taxation is extremely skewed in Greece, with the highest decile of wage earners accounting for nearly 60 percent of total income tax revenue.

It is certainly true that those who earn the most should contribute the most. But the exceptionally generous exemptions of the middle class that apply in Greece cannot be justified by arguments about social fairness and justice. The wholesale exemptions are anything but socially fair and just, as they prevent Greece from raising the revenues it needs to pay for well-targeted social benefits common in the rest of Europe, such as welfare and unemployment. In our view, broadening the tax base while lowering the high marginal tax rates should be a priority.

Moreover, the Greek authorities' reliance on further compression of discretionary spending is not credible. Spending on goods and services, for example, has been slashed dramatically in recent years and is by now reduced to exceptionally low levels by European standards (Chart 4). Indeed, we believe that this compression cannot be sustained, as is evident from complaints that hospitals are functioning without syringes, buses are immobilized by lack of spare parts, etc. In view of this, we find it both highly implausible and undesirable that discretionary spending would decline by a further 2 percent of GDP by 2018, as the authorities expect. With no underlying public sector reforms to generate efficiency gains, targeting such a further compression would imply an even more severe impairment to deliver basic public services, which is not credible and cannot be supported by an IMF arrangement.

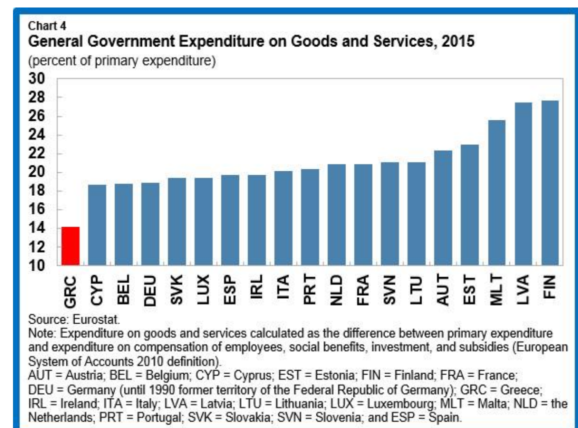


Chart 4
General Government Expenditure on Goods and Services, 2015
(percent of primary expenditure)
Source: Eurostat.
Note: Expenditure on goods and services calculated as the difference between primary expenditure and expenditure on compensation of employees, social benefits, investment, and subsidies (European System of Accounts 2010 definition).
AUT = Austria; BEL = Belgium; CYP = Cyprus; EST = Estonia; FIN = Finland; FRA = France; DEU = Germany (until 1990 former territory of the Federal Republic of Germany); GRC = Greece; IRL = Ireland; ITA = Italy; LVA = Latvia; LTU = Lithuania; LUX = Luxembourg; MLT = Malta; NLD = the Netherlands; PRT = Portugal; SVK = Slovakia; SVN = Slovenia; and ESP = Spain.

At the same time as basic public services are being squeezed to unsustainable levels, spending on pensions remains unaffordable. Greece pays an average nominal public pension similar to Germany's, despite having much lower productivity. It can only manage to do so through budgetary transfers to the system that are more than four times the Euro area average (Chart 5). But dealing with pensions has proven extremely difficult.

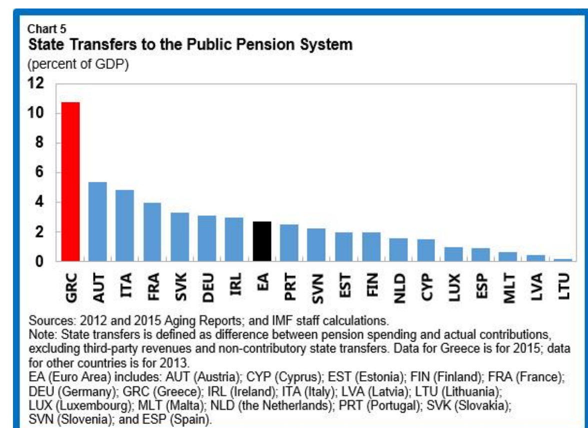
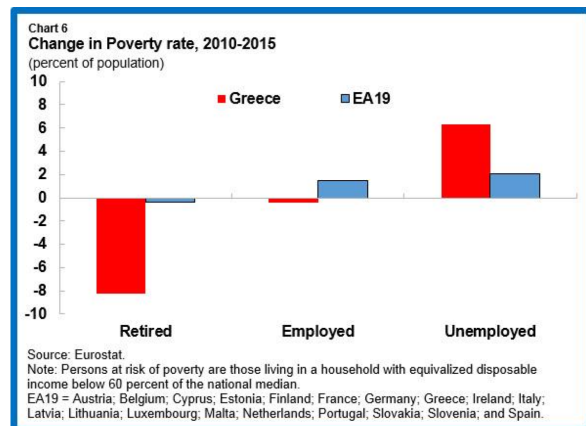


Chart 5
State Transfers to the Public Pension System
(percent of GDP)
Sources: 2012 and 2015 Aging Reports; and IMF staff calculations.
Note: State transfers is defined as difference between pension spending and actual contributions, excluding third-party revenues and non-contributory state transfers. Data for Greece is for 2015; data for other countries is for 2013.
EA (Euro Area) includes: AUT (Austria); CYP (Cyprus); EST (Estonia); FIN (Finland); FRA (France); DEU (Germany); GRC (Greece); IRL (Ireland); ITA (Italy); LVA (Latvia); LTU (Lithuania); LUX (Luxembourg); MLT (Malta); NLD (the Netherlands); PRT (Portugal); SVK (Slovakia); SVN (Slovenia); and ESP (Spain).

Previous governments have attempted to reform the system, but have been faced with court rulings that stopped them and with other setbacks. While the current government has renewed efforts in this area, the recent reform, which aims to reduce budgetary transfers to the pension system by about 1 percent of GDP, is far from sufficient to address the scale of the problem (a deficit of nearly 11 percent of GDP).

As with the tax system, maintaining such high pensions while at the same time denying the population access to basic welfare benefits is neither fair nor socially sustainable. It has been often argued that in Greece, pensions should remain high because they not only serve to protect incomes in old age, but also act as an informal social safety net. However, it is clear that pensions are no substitute for an adequate safety net, as this ad hoc arrangement has not been able to address the rise in poverty of the most vulnerable groups. In fact, the evidence suggests that high pensions have had the opposite effect, constituting an implicit transfer from the most vulnerable members of the working age population to older Greeks. The poverty rate for the working-age population, especially the unemployed, has been rising rapidly since 2010, while pensioners have seen a correspondingly large reduction in poverty levels (Chart 6). To address this problem, the authorities should further reduce current pensions while increasing spending on a modern and well-targeted welfare system to protect those that are most in need. More should be spent on other essential public services and key public investments too. Rationalizing current pension benefits would also ensure a fairer inter-generational burden-sharing of the reform costs.



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