# SPRING REPORT OF THE HELLENIC FISCAL COUNCIL

# MAY 2017

## EXECUTIVE SUMMARY

At the time of drafting the present report, the issue of the agreement between the Greek government and the group of international creditors on the medium and long-term measures that will render Greek debt sustainable, has gained momentum. The lack of consensus at the EUROGROUP meeting on May 22 was a negative development. The next EUROGROUP meeting on June 15 is, thus, crucial for the Greek public debt. The agreement will not focus solely on public debt management, but will also affect a number of other factors driving macroeconomic and fiscal developments. Practically, these measures would allow Greece to participate in the ECB's quantitative easing program (QE), rendering the prospects of gaining access to international capital markets in the near future reasonably realistic. Participation in the quantitative easing program is expected to reduce the current high cost of lending to the Greek banking system. This is associated with (a) improvements in the economy's liquidity conditions, as well as financial support for the anticipated investment activity and (b) credit expansion focusing on private consumption. The anticipated recovery in investment and consumption activity will have a positive impact on macroeconomic and fiscal conditions.

During 2016, the budget performance has been positive. This outcome is mainly due to the reduction of uncertainty in the Greek economy compared to the conditions prevailing in 2015, the significant number of tax measures adopted in 2016 and the increase in electronic transactions. **The primary fiscal surplus in terms of the Financial Assistance Facility Agreement (FAFA) reached 4.18% of GDP**, well above the target set in the FAFA for 2016 (0.5% of GDP). It should be noted that over the last five years, with the exception of 2014, the budgetary targets set in the Economic Adjustment Programs have been largely achieved. In fact, during 2013, 2015 and 2016 budget performance exceeded the targets. There is evidence of a better grip on fiscal policy nowadays, compared with the years preceding the introduction of the economic adjustment programs.

Nevertheless, the creation of a large primary surplus diminishes the available fiscal space, which could be utilized to support sustainable economic growth. **The Hellenic Fiscal Council is of the view that the sustainability of public finances presupposes the recovery of economic activity.**

On a ''national accounting'' basis, the recorded surplus in 2016 in the General Government (GG) accounts, was driven by both a decrease in expenditures and an increase in revenues. Specifically, GG expenditure declined by 9,062 million euro vis a vis 2015. This decrease stemmed mainly from the reduction in capital transfers (by 6,173 million euro), as in 2016 there were no expenditures for banks' recapitalization. On the GG revenue side, there was a significant increase by 2.653 million euro or 3.1% compared to 2015. This rise is almost entirely attributable to the increase in tax revenues (6.2%) and social security contributions (2.1%).

On a ‘‘cash accounting’’ basis, all GG subsectors exhibited improved budget performance in 2016, compared to 2015. As far as the State Budget (SB) transfers to the pension system are concerned, it should be noted that they are currently higher than the EU average. By contrast, overall social expenditure is below the EU average. In this context, the Medium Term Fiscal Strategy (MTFS) (2018-2021) allows partial reallocation of the State funding from pensions to other social uses (school meals, housing allowances, nursery pre-school education support, employment policies). It should be noted that the increased revenues of Social Security Funds (SSF) are mainly due to an increase in transfers from the State Budget. Furthermore, SSF arrears amounted to 2,024 million euro, representing approximately 44% of total GG arrears. **Thus, the SSF remain a key area of concern, leaving no room for complacency.**

There has been a substantial increase in budget surplus in the **Central Government accounts** (Central Administration excluded). However, managing the outstanding amount of public sector guarantees remains a critical issue. Out of a total amount of approximately 12 billion euro in public guarantees, special attention should be paid to over 3.7 billion euro in guaranteed business loans, as well as loans provided to individuals through commercial banks. To a large extent these loans have constituted part of a parallel “hidden” fiscal policy agenda and there are serious indications that they have been included in the bulk of “non-performing loans” (NPLs) of the banking sector. It is also noted that the total outstanding amount of guarantees of non-GG entities (at 6.7 billion euro) has not been included in the GG’s debt, a fact that may lead to additional fiscal burden. The burden could take the form of extra budget expenditures or equivalent increases in the Central Administration’s contingent liabilities, in case the latter eventually assumes the entities’ debt. This is an issue of serious concern that requires special attention.

**The Local Government budget** recorded a surplus of 551 million euro (compared to a surplus of 453 million euro in 2015) and a low and quite stable ratio of State Budget transfers to Local Government entities (around 2.3% of GDP), implying that local government entities are not a source of serious fiscal concern.

Regarding the revenue side of the Ordinary Budget (OB), the positive outcome is mainly due to the improved performance in the field of **tax revenues**. With respect to **direct taxes**, the “over-performance” was mainly due to the contribution of:

- **corporate income taxes** that increased by 37% compared to 2015. This performance was mainly due to the increase in the corporate tax rate from 26% to 29%, and the increase in the advanced-payment rates for income tax.
- **property taxes**, almost exclusively due to **ENFIA**[1]. Its increase by 13.3% is attributed to changes in the way land is included in the calculations, to additional tax imposition and to the abolition of the 2014 and 2015 tax rebates for semi-finished and empty properties, as well as properties not yet supplied with electrical power. The increased collectability rates of the tax are also noteworthy.

[1] Consolidated Tax on Property Ownership

Regarding **indirect taxation**, the recorded “over-performance” is due to:

- the **Value-added Tax (VAT)**; its improved performance can be attributed (a) to the improved performance of the newly implemented measures, such as the increase in the regular VAT rate from 23% to 24%, the redistribution of products/services from lower to higher VAT rate categories and the abolition of the reduced VAT rate regime for some Aegean Islands, (b) to the intensification of preventive tax audits in the summer season and (c) to the continuous increase in electronic transactions, which may have restricted tax evasion.
- **taxes on consumption**, with the large part of the improved performance stemming from insurance premium taxes (a 30% surge vis a vis 2015, due to an increase in the tax rate in other sectors insurance premia and the abolition of tax exemptions) and vehicle registration taxes on passenger cars (65% increase relative to the previous year, possibly due to an 11% increase in new car registrations)
- **indirect taxes of previous financial years**, which recorded an increase of 67.3% mainly due to the improved performance in revenue arrears from VAT.

It is questionable whether the recorded revenue over-performance can be maintained in the coming years, or in other words, whether the tax measures adopted are of a permanent or temporary (i.e. one-off) nature. In this respect, **the Hellenic Fiscal Council considers the majority of the measures to be permanent and adequate to support the enhanced public revenue momentum. However, the permanent nature of the measures does not by itself guarantee their high performance in the future.** For this to be achieved, it is necessary that economic activity recovers and other specific economic factors contribute as well, by means of removing uncertainty, increasing employment and private consumption, etc.

In 2016, the level of **Regular Budget expenditures** was similar to that in 2015. **According to the Hellenic Fiscal Council, this implies that public expenditures are better monitored and control is more effective than in the past, since the level of expenditures has remained stable over the last years and the projections are generally confirmed.**

For 2016, expenditures of the **Public Investments Program** amounted to 3.6% of GDP, namely 6,288 million euro, slightly reduced (by 118 million euro) relative to 2015.

**In the first quarter of 2017 the following fiscal outcomes were achieved**[2]: At the GG level, the GG budget recorded a deterioration, resulting to a 281 million euro deficit, compared to a surplus of 828 million euro in the corresponding period in 2016. The GG recorded a lower primary surplus (2,043 million euro) than in the corresponding period of the previous year (3,214 million euro). The deteriorated y-o-y performance at a GG level is the result of a notable decline in GG revenues by

[2]The data concerning the GG budget execution for the period January to April are expected to be published in June, i.e., after the publication of the Hellenic Fiscal Council’s Spring Report. For this reason, the analysis at a GG level covers only the first quarter of 2017. By contrast, data concerning the SB execution over the first four months of 2017 were available on 24 May 2017 and, thus are included in the analysis of the execution of the SB.

8.6%. The reduced GG revenues reflect mainly a 50% reduction in transfers received from entities outside the GG (from 3,074 million euro in 2016 to 1,527 million euro in 2017). On the contrary, GG expenditure contributed positively to the GG balance in the period under review, recording a reduction of 3.1% compared to the previous year.

More encouraging are the results of **the four-month period (January-April) of 2017,** at the State Budget level. During this period, the State Budget balance recorded a deficit of 1,142 million euro (0.6% of GDP), compared to a 973 million euro deficit in 2016. However, the State Budget primary surplus stood at 1,726 million euro (1.0% of GDP), compared to a primary surplus of 1,905 million euro (1.1% of GDP) in the same period in 2016. The shortfall in relation to the target is attributed to the decreased revenues of the Public Investment Budget (PIB) (amounted to 742 million euro against a target of 1,408 million euro) and to non-tax revenues, mainly from privatization, which were below the four-month target by 411 million euro. However, **tax revenues** evolved at comparable levels to those in 2016 and as a result during the first quarter of 2017 the Ordinary Budget revenues (pre-tax refunds) grew by approximately 5% vis á vis 2016, amounting to 15,821 million euro (a marginal increase by 123 million euro compared to the target). **The Hellenic Fiscal Council regards these developments as an indication that the 2016 tax revenue over-performance can be maintained.**

Regarding **actual State Budget expenditures** for the period January–April 2017, they amount to 16,442 million euro, below previous estimates (targets) by 1,728 million euro. This spending tightening reflects developments in the primary expenditures of the Regular Budget and the Public Investments Budget. It is possible however that this restraint —relative to the targets— will have only a temporary effect on the State Budget. Especially during the last two years, Regular Budget expenditures are executed at a rate equal to 98.5% and 99.5%, respectively. A high execution rate is expected for the current year as well.

**Regarding macroeconomic developments, the Hellenic Fiscal Council is of the view that the path followed by the Greek economy during 2016 suggests two contradictory conclusions.** On the one hand, the negative projections for yet another year of recession were not confirmed. On the other hand, the strong economic expansion observed in the third quarter of 2016 did not succeed in stimulating annual growth. In the last quarter of 2016 the economy returned to recession. As a result of the above factors, the real GDP remained stagnant (relative to 2015).

However, it is quite encouraging that over the last three years, the **GDP has shown some tendency for stabilization**, after a long and deep recession. There are clear indications that the Greek economy is heading towards the end of the ongoing recession. Moreover, **the key issue for the economy is to move unabated from episodes of transient recovery to continuous and sustainable growth.** For this reason, there is no room for complacency: the risk of chronic stagnation is lurking, threatening the Greek economy with protracted “imbalances”, the main characteristics of which will be high unemployment rates and a sluggish, if not staggered growth.

**The Hellenic Fiscal Council considers the forecast revision for real GDP growth in 2017 at 1.8% (compared to the original forecast for +2.7%) a more realistic target.** The main reasons for the downward revision of the 2017 real GDP projections are the following: the non-completion of the second review of the economic adjustment program that fueled economic uncertainty during the early months of 2017, as well as the negative carry-over effect from the last quarter of 2016, since the year ended with 1.1% recession on a y-o-y basis.

The target for the growth projection of **1.8% is assessed by the Hellenic Fiscal Council as optimistic, albeit achievable under certain conditions**. These are: the smooth completion of the current program and the participation of the Greek banking system in the ECB's quantitative easing program (QE).

The projection for the **upward trend in Greek GDP for 2017 relies almost entirely** on the increase of **gross fixed capital formation** (i.e. public and private investments) and on **private consumption**. For the increased investment in 2017, as well as for the prospect of maintaining momentum for the years to come, a few important conditions need to be met: the elimination of uncertainty, the significant improvement in the investment and business climate, the implementation of the privatization program, the normalization of the banking system conditions and the gradual removal of restrictions on capital controls. Regarding the stimulation of **private consumption**, additional measures that could help are: a reduction of public arrears, credit expansion focusing on private consumption, a significant decline in unemployment, as well as a planned and "targeted" distribution of a "social dividend" in case of fiscal over-performance.

For the projected macroeconomic scenario to materialize, a number of **significant risks should be overcome**. Of primary importance for 2017 are the risks associated with the substantial delays observed in the completion of the second review process of the ongoing economic adjustment program, as well as the course of consultations regarding the settlement of the Greek public debt. **Both have a severe negative influence** on investment activity as the latter adjusts to changing economic conditions. Any negative (downside) risk should nonetheless be weighed against the positive scenario of gradually restoring the country's financial and banking system. As for the external sector of the economy, despite looming political and geo-strategical risks, as well as the uncertain trends surrounding the status of international cooperation, **the risk of an increase in import demand still exists**. This can weaken the magnitude of the positive effects of a possible upturn in investment activity, especially in case the latter exhibits strong positive correlation with demand. Other sources of **uncertainty** surrounding the macroeconomic projections for 2017 include an unforeseen fiscal misalignment, as well as the gradual impact of a contraction in productive capacity on the economy's potential output.