COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

Greece

Report prepared in accordance with Article 104(3) of the Treaty

1. INTRODUCTION AND JUSTIFICATION OF THE REPORT

On 7 April 2004, the Commission published its spring 2004 forecasts. According to these forecasts, which took into consideration revised data reported by Greece on 30 March 2004, but not validated by Eurostat, the 2003 general government deficit in Greece reached 3.0% of GDP. However, at the time of preparation of the forecasts, it was already apparent, that data for 2003 were far from robust and would be subject to potentially significant revision. Following contacts between Eurostat and the Greek authorities at the end of April, the latter submitted on 4 May a further revised notification of a deficit of 3.2% of GDP for 2003. There are strong indications that there will be significant further, and as regards deficits almost certainly upward revisions for 2003 and earlier years, when a new notification is made in September 2004. The quality of existing data is discussed further in this report. It should be understood, therefore, that the data used here are provisional and also subject to problems of consistency, since the Commission Spring forecasts were prepared before the latest revision of the 2003 deficit.

Table 1: General government balance and debt (% of GDP)

	1998	1999	2000	2001	2002	2003[a]	2004[b]	2005[b]
General government balance	-2.5	-1.8	-2.0	-1.4	-1.5	-3.2	-3.2	-2.8
General government gross debt	105.9	105.2	106.2	106.9	104.7	103.0	102.8	101.7

a Based on second revised EDP notification of 4 May 2004

b Based on the first revised EDP notification of 30 March 2004

Source: Eurostat, May 2004 EDP notification and Commission 2004 spring forecasts

At this stage, the second revised notified figure for the 2003 deficit provides evidence on the existence of an excessive deficit in Greece, in the sense of the Treaty and the Stability and Growth Pact. Moreover, the high level of government debt and its slow pace of reduction are cause of concern. In the light of this evidence the Commission has decided to initiate the excessive deficit procedure (EDP) for Greece.

The application of the EDP is governed by Article 104 of the Treaty and Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact (SGP).

Article 104(3) of the Treaty stipulates that "if a Member State does not fulfil the requirements under one or both of these criteria[1], the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State. …"

[1] The criteria are (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds the reference value of 3%, unless: either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value; (b) whether the ratio of government debt to gross domestic product exceeds the reference value of 60 %, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The present report prepared by the Commission according to Article 104(3) assesses recent and current budgetary developments in Greece and reviews the short-term prospects in the light of overall economic conditions and policy action taken by the government.

2. RECENT MACROECONOMIC DEVELOPMENTS AND PROSPECTS

From the second half of the 1990s Greece experienced a period of economic expansion which has since continued almost without interruption, despite the worldwide downturn from 2001. After real GDP growth in the period 1995-1999 averaging 2.9%, growth accelerated to an average 4.1% in the period 2000-2002. This performance was led mainly by investment spending, in particular in the framework of the preparation of the 2004 Olympic Games and of accelerating financial flows from the EU Structural Funds.

Table 2: Macroeconomic developments and outlook

	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	3.4	3.4	4.4	4.0	3.9	4.2	4.0	3.3
Contribution: Domestic demand	4.9	4.5	3.6	3.5	4.1	6.6	4.4	3.8
Change in inventories	-0.6	-0.4	0.5	-0.3	0.1	0.1	0.2	0.0
External trade	-1.6	-0.8	0.4	0.9	-0.4	-2.7	-0.2	-0.7
Output gap[a] (% of potential GDP)	-1.5	-1.0	-0.2	0.6	0.8	1.5	2.2	2.3
Unemployment rate (% of labour force)	10.9	11.8	11.0	10.4	10.0	9.3	8.4	8.0
Unit labour costs (% change)	5.8	3.1	1.6	0.9	4.7	5.6	4.6	3.9
HICP (% change)	4.5	2.1	2.9	3.7	3.9	3.4	3.4	3.5

[a] Based on the commonly agreed method

Source: Eurostat and Commission 2004 spring forecasts

Following this pattern, the economy continued buoyant in 2003, with real GDP growth estimated at 4.2% and the output gap rising to an estimated 1.5% of GDP. Private consumption has continued on its upwards trend, underpinned by high wage increases and tax reductions caused by the tax reform[2]. Although export activity started to recover, the negative contribution of the external balance to GDP increased, given the sharp acceleration of imports. In 2004, according to the Commission Spring 2004 forecast, the economy is

[2] In 2002 the government embarked on a major tax reform based on the principles of simplification, transparency, neutrality, and equity. The main goals of this reform are to simplify the quite complex tax system, to redistribute the tax burden from movable to immovable capital assets, to reduce the tax burden on labour, to rationalize the gift and inheritance taxes, and to reduce differences in the tax treatment of the corporate and non-corporate sectors. The overall cost in terms of tax revenue was estimated in the region of 0.8-1.0% of GDP, split over the years 2003 and 2004. For further detail, see the 2002 and 2003 updated stability programmes and the assessment of the 2003 update of the stability and growth programme of Greece.

expected to grow by 4.0%, slowing to 3.3% in 2005. The positive output gap is expected to expand further, to 2.2% of GDP in 2004 and 2.3% in 2005. Growth should continue to be led by domestic demand but with investment increasing at a slower rate than in 2003, as works associated with the Olympic Games wind down. The continuously buoyant domestic demand growth together with strongly increasing unit labour costs and a deteriorating external account raise concerns about the downward risks to the medium term growth outlook. Moreover, the current influence of temporary growth-boosting factors suggests a slowdown in economic activity in the near future.

The unemployment rate remains among the highest in the EU. The rate was slightly reduced from 10-11% in the period 1998-2002 to 9.3% in 2003 as employment growth started to respond to booming economic activity. It is expected to decrease further to 8.4% in 2004 and 8.0% in 2005.

HICP inflation decreased from 3.9% in 2002 to 3.4% in 2003, mainly accounted for by lower import prices, in particular of imported raw materials, due to the strong euro. Price developments by sector point clearly to the services sector as the predominant source of persisting price pressures. HICP inflation is expected to remain high, averaging marginally below 3.5% during the forecasting period.

3. THE SITUATION OF GOVERNMENT FINANCES

At present the quality of public finance data remains uncertain, and revisions are expected this year in the September EDP notification. These revisions may have a significant impact on the analysis. This report has necessarily been based on the public finance data released by the Greek authorities on 4 May (second revised EDP notification) which must be regarded as provisional. In particular, while earlier reported deficits must now be considered subject to a significant downward bias, deficit data prior to 2003 have not been revised.

According to these provisional data, general government deficits were contained in the range of 1½-2% of GDP in the period 1999-2002. However, despite strong economic growth, this pattern was interrupted in 2003 when the implementation of the 2003 State budget turned completely off-track. The second revised notification of May 2004 indicates a general government deficit of 3.2% of GDP for 2003 compared to a targeted deficit of 0.9% set in the December 2002 update of the stability programme. The breach of the 3% of GDP reference value appears due to a revenue shortfall and to higher than planned primary spending, including certain extraordinary funding, in particular related to preparation of the Olympic Games. Given the positive and widening output gap in 2003 the sharp rise in the cyclically-adjusted deficit indicates a pro-cyclical, expansionary fiscal stance. According to Commission forecasts based on announced policies and the first revised notification of 30 March, the deficit will remain above 3% of GDP in 2004.

3.1. Recent budgetary developments until 2002

From the start of the second stage of EMU, the stance of fiscal policies in Greece changed drastically in the direction of fiscal consolidation, which continued up to 1999. The achievement in terms of deficit reduction was impressive. The continuously lower interest payments have contributed significantly to this development. From 10.2% of GDP in 1995 the general government deficit fell to 2.5% of GDP in 1998 - when Greece joined the ERM - and to 1.4% of GDP in 2001 when Greece adopted the euro. In 1999 the deficit continued downwards trend to reach 1.8% of GDP, and the primary surplus of 6.5% of GDP was over double that of 1995, making a significant contribution to the deficit reduction. Cyclically-adjusted balances improved continuously up to 1999, but, since the economy was still growing below potential, only a relatively small amount of the total improvement of the government balance can be attributed to cyclical effects.

Table 3: GDP growth and general government balance and debt

(% of GDP, unless otherwise indicated)	1998	1999	2000	2001	2002	2003[a]	2004[b]	2005[b]
Real GDP (% change)	3.4	3.4	4.4	4.0	3.9	4.2	4.0	3.3
General government balance	-2.5	-1.8	-2.0	-1.4	-1.5	-3.2	-3.2	-2.8
Primary balance	6.5	6.5	5.9	5.7	4.7	2.5	2.4	2.7
Total expenditures	48.7	47.6	49.8	47.8	46.8	47.2	47.2	46.9
- of which: investment	3.6	3.5	4.1	4.0	3.8	4.2	4.2	4.2
Total revenues	45.3	45.8	47.8	46.4	45.3	44.0	44.0	44.1
General government gross debt	105.9	105.2	106.2	106.9	104.7	103.0	102.8	101.7
Cyclically-adjusted balance	-1.8	-1.3	-1.9	-2.2	-1.7	-3.9	-4.1	-3.8

[a] Based on second revised EDP notification of 4 May 2004
[b] Based on the first revised EDP notification of 30 March 2004

Source: Eurostat, May 2004 EDP notification and Commission 2004 spring forecasts

A loosening in fiscal policy was initiated in late 1999 with the announcement of a reduction of indirect taxes, accompanied by a benefit package. At the same time, impressive growth in economic activity induced an increase in the government revenues from direct taxation. The overall result was that in 2000 the total revenue ratio increased by 2 pp of GDP. However, due to the increases in the wage bill and social transfers, as well as after a data revision carried out by Eurostat, the deficit rose to 2.0% of GDP, while the primary surplus fell to 5.9% of GDP. The cyclically-adjusted deficit deteriorated to 1.9% of GDP from 1.3% of GDP in 1999.

For 2001 and 2002 the general government balance targets in the 2001 stability programme were recorded at the time as fully met: a surplus of 0.1% of GDP in 2001 and 0.8% in 2002. The favourable domestic economic conditions in combination with measures of further containment of tax evasion and enhancement of the tax base contributed to an increase in total revenues at the targeted rates. However, after the reclassification by Eurostat in autumn 2002 of some expenditure, in particular debt assumptions and capital injections, the surpluses recorded for 2001 and 2002 were revised as deficits of 1.4% of GDP for 2001 (including UMTS receipts of 0.5% of GDP) and 1.5% of GDP for 2002. The primary balance fell further to 5.7% of GDP in 2001 and 4.7% of GDP in 2002. The cyclically-adjusted deficit also deteriorated further in 2001, to 2.2% of GDP but recovered to 1.7% in 2002. In total, only about half of the total improvement of the government deficit during the period 2000-2002 can be considered structural.

3.2. Budgetary developments in 2003

The second revised EDP notification of 4 May 2004 indicates a deficit of 3.2% of GDP in 2003, thus exceeding the 3% of GDP Treaty reference value. The deterioration in the general government balance in 2003 from a year earlier was the result of a sharp worsening in the balance of the central government.

The general government deficit of 2003 compares with a target deficit of 0.9% of GDP set in the December 2002 updated stability programme. The significant slippage is attributable, first, to extraordinary factors (expenditure overruns related to the preparation of the Olympic Games and compensation for weather damages), secondly, to higher than planned primary spending (social transfers and public sector wages) and finally to a shortfall of budgetary revenues (VAT and income taxes). With a positive output gap of 1.5% in 2003, up from 0.8% in 2002, the sharp deterioration of the government balance cannot be attributed to cyclical factors. The estimated cyclically-adjusted deficit rose from 1.7% of GDP in 2002 to 3.9% of GDP in 2003, and the primary surplus fell from 4.7% to 2.5% respectively.

Table 4: Successive targets for the 2003 general government balance and estimated outcome

	Real GDP growth (%)	General government balance (% of GDP)
November 2002: draft budget for 2003	3.8	-0.9
December 2002: 2002 updated stability programme	3.8	-0.9
December 2003: 2003 updated stability programme	4.0	-1.4
April 2004: Commission spring forecasts	4.2	-3.0
May 2004: Second revised EDP notification		-3.2

Source: Commission services

3.3. Prospects for 2004

The December 2003 updated stability programme, consistently with the 2004 budget presented in December, set a target for the general government deficit for 2004 of 1.2% of GDP. In the Commission spring forecasts, the projected outcome for 2004 is of a general government deficit of 3.2% of GDP. Apart from the obvious base year effect, this is due, first, to the impact of the 2003 social package[3], which seems to have been understated in the budget's expenditure projections; and secondly, to lower than officially projected growth in tax revenues, given the recent tax reform. The worsening of the general government balance projected in the Commission spring forecasts, in combination with an expected further rise in the positive output gap (to 2.2% of potential GDP), reflects the continuation of a pro-cyclical,

[3] In September 2003, the government announced a series of measures, the so-called "social package", according to which in 2004 there will be increased transfers to low-income pensioners and some other social groups beyond those contained in the December 2002 updated stability programme. The overall budgetary cost of the 2003 social package was estimated by the government at 1.4% of GDP, split over 0.3% of GDP for 2003 and 1.1% of GDP for 2004.

expansionary fiscal stance. According to the forecasts, the cyclically-adjusted deficit in 2004 will deteriorate to 4.1%, indicating a move further away from the position of close to balance or in surplus.

3.4. Recent debt developments and prospects

The gross debt to GDP ratio in Greece remains well above the 60% Treaty reference value. It has declined slowly, despite some improvement of the primary balance from the 1990s, strong nominal growth and the prevailing low interest rates, in particular since the adoption of the euro in 2001. In 2003 the debt ratio fell to 103.0% from 104.7% the previous year and compared with a projected 100.2% in the December 2002 update of stability programme.

In accounting terms, the slowness of the decline in the debt ratio is due to large stock-flow adjustments. Such adjustments, which peaked at 6.8% of GDP in 2001, were still high in 2002, standing at 4.2%, before falling to 2.8% in 2003. From 1994 to 2003 these large effects on the stock of debt amounted to a cumulative 40 percentage points of GDP. They have been recorded despite sizeable privatisation receipts acting to reduce the stock-flow adjustment: in the period 2001-2003, privatisation proceeds, used to retire public debt, amounted to a cumulative 6% of GDP.

Table 5: Debt dynamics

(% of GDP)	1998	1999	2000	2001	2002	2003[a]	2004[b]	2005[b]
Government gross debt	105.9	105.2	106.2	106.9	104.7	103.0	102.8	101.7
Change in debt ratio (1= -2+3+6)	-2.5	-0.6	0.9	0.7	-2.1	-1.8	-0.2	-1.1
Primary balance (2)	6.5	6.5	5.9	5.7	4.7	2.5	2.4	2.7
Snow-ball effect (3=4+5)	0.2	1.8	0.1	-0.4	-1.6	-2.1	-2.0	-0.8
Interest expenditure (4)	9.0	8.3	7.9	7.1	6.2	5.7	5.6	5.5
Contribution of nominal GDP growth (5)	-8.8	-6.5	-7.8	-7.5	-7.8	-7.8	-7.6	-6.3
Stock-flow adjustment (6)	3.8	4.1	6.7	6.8	4.2	2.8	4.2	2.4

[a] Based on second revised EDP notification of 4 May 2004
[b] Based on the first revised EDP notification of 30 March 2004

Source: Eurostat, May 2004 EDP notification and Commission Spring 2004 forecasts.

There appear to be a number of factors that have produced such significant stock-flow effects. First in importance is the accumulation of financial assets by the social security sector. Second is the very high level of payments in relation to the purchase of military equipment in Greece; in national accounts, such expenditure is recorded upon equipment deliveries which do not necessarily coincide with cash payments; in 2003 these payments reached 0.9% of GDP as compared to 1.7% in 2002[4]. Thirdly, the relatively high external debt is exposed to

4 Note however that social security accounts, including the accumulation of financial assets, and military expenditure are subject to potentially considerable revision by September 2004 (see Section 3.5 below).

exchange rate fluctuations which can give rise to large positive stock-flow adjustments in periods of currency depreciation, though this element is obviously much less marked since adoption of the euro in 2001. Finally, systematic differences between cash and accruals accounting have also played a significant role.

Sizeable debt assumptions and capital injections to public enterprises have also contributed significantly to increasing the stock of debt (although since autumn 2002 most of these have been correctly recorded as deficit-increasing spending). In 2002, Eurostat requested that securitisation proceeds, convertible shares and exchangeable bonds were included in the stock of debt. This resulted in a significant upward revision of the debt ratio to 106.9% of GDP in 2001 and to 104.7% in 2002.

According to the 2004 spring forecast, the debt ratio is projected to decline marginally in 2004, given a further high stock-flow adjustment: a projected 102.8% of GDP at end-2004 compares with 94.6% in the December 2003 update of the stability programme.

3.5. Pending issues in relation to the quality of the Greek government accounts

The quality of the Greek government accounts, in particular their compliance with the ESA95 accounting rules, has been the subject of bilateral contacts between Greece and the Commission (Eurostat) for several years.[5] At the moment, the most relevant pending issues concern the recording of military expenditure, the surplus of social security, the classification of pension schemes and the recording of EU structural funds-related revenue.

In principle, military equipment should be recorded as government expenditure at the time of delivery, irrespective of payments which can take place when the equipment is ordered, during construction, upon delivery or even at a later stage. However, given that information on the delivery of military equipment is classified, the National Statistical Service of Greece (NSSG) has not been able to record all purchases as government expenditure, and expenditure on military equipment has been underreported. The NSSG has committed itself to try to get from the Greek Ministry of Defence complete information on equipment deliveries by June 2004. If this is not possible, then military expenditure will be imputed in the reporting due by September 2004 on the basis of known cash payments. In any case, available evidence suggests that government expenditure and hence deficits will have to be revised considerably upwards.

The NSSG has not compiled basic data from social security units since 2000. Data for 2001, 2002 and 2003 have been estimated on the basis of macroeconomic indicators and other incomplete information. Therefore, the reported social security surpluses (2.3% of GDP for 2000, 2.6% for 2001, 3.3% for 2002 and 3.7% for 2003) are subject to wide margins of error. Moreover, the existing data are not internally consistent and there is no evidence of an accumulation of assets of the magnitude of the reported surpluses. The NSSG has committed itself to collect complete data from social security and to include the revised accounts in the September 2004 reporting. Moreover, the NSSG will also provide information, by the end of June 2004 to enable Eurostat to check the sectoral classification of pension schemes.

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5 In the past, Eurostat either did not certify data provided by Greece or has unilaterally amended such data, in March and September 2000 and March 2001 ("as reported data [were] not yet fully adjusted to ESA95"), in March 2002 ("due, among other reasons, to the lack of information on share convertible bonds") and in September 2002 ("as certain information on government transactions is still pending or incomplete"). Following each of these episodes, the accounts were revised.

Data on revenue from EU structural funds in the Greek government accounts are not consistent with information from the Communities' budget and the Greek balance of payments. In part, this is because, according to the ESA95 rules, revenue should be recorded on an accruals basis and not at the time of cash receipts. However, the differences between the above-mentioned sources are considerably higher than in other Member States. The NSSG has committed itself to provide information on the discrepancies by the end of June 2004.

4. OTHER RELEVANT FACTORS

4.1. Medium-term prospects

The 2003 updated stability programme projected an improvement in the general government deficit from 1.2% of GDP in 2004 to 0.5% of GDP in 2005. In 2006 the general government deficit would be brought down to balance. In the light of the latest reported data and the projections in the Commission 2004 spring forecast, these targets appear out of reach under current policies. According to the Commission spring forecasts, the general government deficit, under the assumptions of unchanged policy and that primary expenditure related to the preparation of the Olympic Games will not be recurring in 2005, was forecast to be 2.8% in 2005; the cyclically-adjusted deficit was projected to improve slightly compared with the position in 2003, though to remain far from a position of close to balance or surplus.

4.2. Investment

Article 104(3) of the Treaty foresees that the present Commission report "shall also take into account whether the government deficit exceeds government investment expenditure". The gross public investment to GDP ratio in Greece has followed an irregular but broadly upward trend in the last six years. The ratio, 4.2% of GDP in 2003, the highest among the EU-15, remained significantly higher than the deficit-to-GDP ratio during the whole period considered. It is projected to remain so during 2004-2005. This is consistent with the public investment needs linked to the catching-up process of the Greek economy.

4.3. Long term sustainability of public finances

Greece did not include an analysis of long-term sustainability of public finances in its last update stability programme, presented on 1 December 2003. According to the Council Opinion on the update, on the basis of current policies and taking also into account the high debt ratio, there is a serious risk of significant budgetary imbalances emerging due to an ageing population in Greece. Pension expenditure is projected to increase to a level that would be well above other EU countries. The budgetary strategy outlined in the update consisted of the reduction of the deficit to reach a position close to balance in nominal terms by 2006. According to the Commission assessment, such a strategy did not appear sufficient to improve the sustainability of public finances and more ambitious targets for the budget balance had to be pursued. Moreover, the new data in the notification of 4 May indicates that the achievement of the balanced budget would be postponed, thus further worsening the sustainability of the Greek public finances in the long term.

5. CONCLUSIONS

Greece's public finances show large imbalances, inconsistent with a prudent fiscal policy. Moreover, the quality of data is not satisfactory. Deficit figures in particular remain subject to potentially significant revision. The May 2004 notification is of a general government deficit of 3.2% of GDP in 2003. This was in a context of strong economic growth and with a further widening of a positive output gap. The excess of this deficit over the 3% of GDP Treaty reference value did not therefore result, in the sense of the Stability and Growth Pact, from an unusual event outside the control of the Greek authorities, nor is it the result of a severe economic downturn.

According to the Commission spring forecasts, based on announced policies, the general government deficit, estimated to reach 3.2% of GDP, would remain above the reference value in 2004. This estimated government deficit was based on the then available first revised notification of 30 March which indicated a lower 2003 deficit than that of the second revised 4 May notification. The gross government debt is estimated to decline only slightly to 102.8% of GDP in 2004 from 103.0% of GDP in 2003, thus remaining widely in excess of the 60% of GDP Treaty reference value.