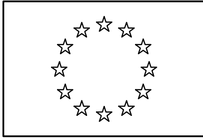

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 22 April 2005
ECFIN/REP/51242/05-EN

MARCH 2005 REVISED UPDATE OF THE STABILITY PROGRAMME OF GREECE (2004-2007)

AN ASSESSMENT

(Note for the Economic and Financial Committee)

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SUMMARY AND CONCLUSIONS[1]

The Greek 2004 revised update of the stability programme was submitted on 21 March 2005 and covers the years 2004 to 2007. The targets in the programme take into account the budgetary impact of a fiscal package, made public by the government on 29 March to underpin the implementation of the revised programme, including a public commitment to target a deficit below 3% of GDP in the 2006 draft budget. The programme partly complies with the data requirements of the "the code of conduct on the content and format of stability and convergence programmes".[2]

In view of a general government deficit of 3.2% of GDP and a debt ratio of 103.0% of GDP recorded in 2003, the Council decided that Greece was in excessive deficit on 5 July 2004 and recommended that the excessive deficit be corrected by 2005 at the latest. On 18 January 2005, the Council decided that Greece had not taken effective action in response to these recommendations. On 17 February 2005, also upon a Commission recommendation in accordance with Article 104(9), the Council decided to give notice to Greece to take measures for the deficit reduction below the 3% of GDP threshold by 2006 at the latest. The Greek authorities were also required to identify and control factors other than net borrowing, which contribute to the change in debt levels, and to improve the collection and processing of general government data.

The programme considers three different macroeconomic scenarios. The so-called baseline scenario essentially coincides with the macroeconomic framework provided in the 2005 budget. It optimistically assumes that the Greek economy will manage to sustain the economic momentum gathered until 2004 thanks to strong domestic demand. This scenario is clearly outside the current range of forecasts. In a second, less buoyant scenario, which is in line with the already outdated Commission services autumn 2004 forecast, GDP growth is projected at 3.3% over the programme period. Finally, in the third scenario, real GDP is projected to grow at 2.9% in 2005 and marginally accelerate to 3% in 2006 and 2007, which is essentially in line with the Commission services spring 2005 forecast. Consequently, based on the latest available information, this third scenario should be considered as the most plausible and used as reference for assessing the programme. The data in the scenario imply a rate of potential output growth that gradually eases over the programme period from around 3.3% in 2005 to 3% in 2007. This is also broadly in line with the estimates derived from the Commission services 2005 spring forecast. The deceleration in the underlying rate of growth is estimated to result from total factor productivity. The sizeable positive output gap recorded in 2004 is set to narrow somewhat up until 2007.

According to the March 2005 reporting of deficit and debt levels in accordance with Council Regulation (EC) No. 3605/93 (henceforth EDP notification), the general government balance is estimated to have recorded a deficit of 6.1% of GDP (6.0% of GDP according to ESA95 definition, i.e. excluding swap-related flows). This deficit is

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[1] This technical analysis, which is based on information available up to 31 March 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 6 April 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Carlos Martinez-Mongay (carlos.MARTINEZ@cec.eu.int), Nikos Chryssanthou (nikos.Chryssanthou@cec.eu.int) or Martin Larch (martin.LARCH@cec.eu.int).

[2] The programme does not provide data on world GDP growth excluding EU nor the growth rate of relevant foreign markets as required by the code of conduct. Moreover, no details of the measures behind the targets for 2007 are given. Price developments are presented in terms of the deflator of private consumption expenditure and not in terms of Harmonised Index of Consumer Prices.

0.8 percentage points higher than the figure of 5.3% of GDP estimated by the Greek government at the time of the September 2004 EDP notification. The EDP March 2005 notification presents an additional slippage, which includes, besides 0.3 percentage point of GDP higher interest payments, tax shortfalls and expenditure overruns worth an additional half a point of GDP, on top of those already unveiled in the September 2004 EDP notification. On 18 March 2004 Eurostat did not validate the deficit figures for Greece because of an inconsistent recording of flows between Greece and the EU budget. Eurostat also noted that healthcare- and Olympics-related expenditure for past years is not yet final. Therefore the government deficit figures for 2004 and earlier years may have to be revised upwards.

The reference scenario used for the assessment of the programme targets a reduction of the nominal general government budget deficit by 3.6 percentage point over the programme period, from the outturn of 6.1% of GDP in 2004 to 2.4% in 2007. The fiscal adjustment is frontloaded and concentrated in 2005 and, to a lesser extent in 2006, while in 2007 the adjustment amounts to just 0.5 percentage point of GDP. The strategy aims at reducing the deficit to below the 3% of GDP reference value by 2006, in line with the Council decision under Article 104(9). To achieve the targets the programme relies on a mix of revenue-enhancing measures and expenditure retrenchment, which should result in increasing primary surpluses. The primary balance is projected to move from a deficit of 0.4% in 2004 to a surplus of 1.8% of GDP in 2005, rising to 3.3% of GDP at the end of the period. In cyclically-adjusted terms, based on Commission services calculations carried out in accordance with the commonly agreed methodology applied to the data in the programme, the deficit would fall from 7.0% of GDP in 2004 to 4.4% of GDP in 2005, to 3.5% of GDP in 2006, and 3% in 2007.

The deficit targets of the reference scenario are lower than those projected in the Commission services spring 2005 forecast, which projects deficits of 4.5% of GDP in 2005 and of 4.4% of GDP in 2006. A significant part of the differences explained by the budgetary impact in 2005 and carryover effects in 2006 of additional fiscal measures to be implemented in 2005, which were announced after the cut-off date of the Commission forecast and amount to around 0.5 of a percentage point of GDP in 2005 and 0.9 percentage point of GDP in 2006. In addition, there are negative risks to the budgetary outlook for 2005 and beyond on both the revenues and expenditure side. Specifically, the trend projections for social security contributions appear on the high side while those for public consumption, especially health care and public wages, might be underestimated. Therefore, in line with their commitment announced on 29 March, the Greek authorities may have to implement additional measures in 2006, on top of those already announced for 2005, to effectively bring the deficit below the 3% threshold. Net of cyclical factors, the Commission services' forecast for the 2005 and 2006 deficit is above 5%. It stays above 3% of GDP even after taking into account the additional measures taken in March. Hence, the budgetary stance in the programme does not provide a sufficient margin against breaching the 3% of GDP reference value with normal cyclical fluctuations nor does it achieve the Stability and Growth Pact's medium term objective of a budgetary position of close-to-balance or in surplus throughout the programme period.

The debt ratio is projected to decline from 110.5% of GDP in 2004 to only 109.5% in 2005 and then to 107.2% in 2006 and 104.7% in 2007. The increasing primary surplus and high nominal GDP growth would be the main driving forces behind the projected path of debt-reduction. A faster pace of debt reduction is hampered by significant debt increasing stock-flow adjustments (SFA), which, while declining compared to 2004, are expected to remain significant in spite of planned privatisation proceeds. The programme provides a detailed account of the operations behind the SFA in 2004. Therefore, it seems that some progress has been made in identifying the sources of the SFA. However, the

programme does not provide details on the origin of the projected SFA over 2005-2007. The evolution of the debt ratio may be less favourable than projected given the risks to the budgetary targets mentioned above.

The programme reviews the government's structural reform programme, which focuses on the re-orientation of public expenditures towards more productive uses. It also outlines measures to reduce business start-ups costs and to further open up markets to competition, especially network industries. On health-care, the government is preparing a reform aiming at ensuring financial sustainability and addressing some of the weaknesses of the system. However, while the programme does not give much detail of the corresponding measures, the plans for a far-reaching reform are still in a very preliminary stage. On the restructuring of expenditures, the 2005 budget foresees a reduction of consumption expenditure by over 16% in nominal terms. Such spending cuts appear optimistic since they affect certain components of the budget (wages, social transfers), the trends of which have always exhibited strong resilience to spending control measures.

Greece appears to be at serious risk with regard to the long-term sustainability of public finances, also on account of the very important projected budgetary costs of an ageing population. The considerable increase projected in age-related spending suggests that additional measures to control public pension expenditures, including the resolute implementation of reform measures enacted, are necessary. The strategy outlined in the programme is mainly based on the implementation of legislated pension reforms and the necessary consolidation of public finances in the medium-term. Nevertheless, gross debt-to-GDP, while projected to fall, remains above 100% of GDP throughout the programme period. Even if the planned budgetary consolidation should materialise over the programme period, a considerable sustainability gap emerges, pointing to the need for a broad-based approach to ensure the sustainability of the public finances. These results show that a strategy based exclusively on fiscal consolidation does not seem to be feasible.

Overall, the economic policies outlined in the update are partly consistent with the country-specific Broad Economic Policy Guidelines, in the area of public finances. In particular, the programme does not outline sufficiently effective action towards the close-to-balance-or-in-surplus position. The cyclically-adjusted deficit, calculated by the Commission services according to the commonly agreed methodology applied to the data of the reference scenario, although projected to improve by at least 0.5 per cent of GDP per year, would remain above 3% of GDP throughout the programme period. However, within the framework of the Council notice given to Greece on 17 February in accordance to Article 104(9), the Commission[3] has concluded that this budgetary strategy is consistent with the Council recommendations in the notice and that no further steps in the excessive deficit procedure are needed at present. A new assessment of compliance with such recommendations will be carried out on the basis of the report to be presented by the Greek authorities in October, as foreseen in the Council decision.

In view of the above assessment it would be appropriate for Greece to (i) implement the necessary permanent measures leading to the correction of the excessive deficit by 2006 at the latest; (ii) reduce the cyclically-adjusted deficit by at least 0.5% of GDP from 2007 onward, preferably through primary spending control measures, leading to a close-to-balance-or-in-surplus position in the medium term; (iii) enhance the efforts to identify

[3] Commission communication on 'The action taken by Greece in response to the Council note according to Article 104(9) of the Treaty for the deficit reduction judged necessary in order to remedy the situation of excessive deficit (SEC(2005)443 of 6 April 2005),

and control factors other than net borrowing, which contribute to the change in debt levels; in order to ensure a reduction in the government gross debt ratio so as to approach the reference value at a faster pace; (iv) control public pension expenditures and resolutely implement the enacted reforms to ensure the sustainability of the public finances and (v) improve the collection and processing of general government data in collaboration with Eurostat, notably by enhancing the mechanisms that ensure a prompt and correct supply of this data.

Comparison of key macroeconomic and budgetary projections

		2004	**2005**	**2006**	**2007**
Real GDP (% change)	**SP Mar 2005**	**4.2**	**2.9**	**3.0**	**3.0**
	COM Mar 2005	4.2	2.9	3.1	
	SP Dec 2003	4.2	4.0	3.8	n.a.
HICP inflation (%)	**SP Mar 2005**	**3.0**	n.a	n.a	n.a
	COM Mar 2005	3.0	3.2	3.2	
	SP Dec 2003	3.0	2.8	2.6	n.a.
General government balance (% of GDP)(*)	**SP Mar 2005**	**-6.1**	**-3.7**	**-2.9**	**-2.4**
	COM Mar 2005	-6.1	-4.5	-4.4	
	SP Dec 2003	-1.2	-0.5	0.0	n.a.
Primary balance (% of GDP)(*)	**SP Mar 2005**	**-0.4**	**1.8**	**2.7**	**3.3**
	COM Mar 2005	-0.4	1.0	1.0	
	SP Dec 2003	4.7	5.1	5.3	n.a.
Cyclically-adjusted balance (% of GDP)(*)	**SP Mar 2005[1]**	**-7.0**	**-4.4**	**-3.5**	**-3.0**
	COM Mar 2005	-7.1	-5.5	-5.3	
	SP Dec 2003	-1.2	-0.5	0.0	n.a.
Government gross debt (% of GDP)	**SP Mar 2005**	**110.5**	**109.5**	**107.2**	**104.7**
	COM Mar 2005	110.5	110.5	108.9	
	SP Dec 2003	98.5	94.6	90.5	n.a.

Note:
[1]Commission services calculations on the basis of the information in the programme

(*) The Commission projections do not take into account the measures announced on 29 March

Sources:
Stability programme March 2005 revised update (SP); Commission services spring 2005 economic forecasts (COM); Commission services calculations

1. INTRODUCTION

A revised version of the programme was submitted on 21 March 2005 covering the years 2004 to 2007. The economic projections for 2005 are only partially based on the State Budget for 2005, adopted by the Greek Parliament on 22 December 2004. The targets in the programme take account of the budgetary impact of a fiscal package, made public by the government on 29 March, to underpin the implementation of the revised programme. The package also includes the government commitment to target a deficit below 3% of GDP in the 2006 draft budget.

The programme partly complies with the code of conduct. The programme only partially spells out the measures necessary to reach the deficit targets in 2006, and no detail is provided of the measures behind the deficit targets for 2007. Price developments are presented by means of the deflator of private consumption expenditure and not in terms of HICP inflation. As regards the basic external assumptions the programme does not provide data on world GDP growth excluding EU nor the growth rate of relevant foreign markets as required by the code of conduct.

2. MACROECONOMIC DEVELOPMENTS

The programme considers three different macroeconomic scenarios. The so-called baseline scenario essentially coincides with the macroeconomic framework provided in the 2005 budget. Real GDP growth is projected at 3.9% in 2005 and expected to accelerate to 4% in 2006 and 4.2% in 2007. Overall, the baseline optimistically assumes that the Greek economy will manage to sustain the economic momentum gathered in the run-up to the Olympic Games thanks to strong domestic demand, which is expected to more than compensate for the withdrawal of the public sector in terms of lower public investment and expenditure. This scenario is clearly outside the current range of forecasts.

In a second, less buoyant scenario, denoted ‘alternative-1’, GDP growth is projected at 3.3% over the programme period. This scenario is in line with the already outdated Commission services autumn 2004 forecast. Finally, in the third scenario, denoted as ‘alternative-2’, which the government considers as pessimistic, real GDP would grow at 2.9% in 2005 and marginally accelerate to 3% in 2006 and 2007. It is essentially in line with the Commission services spring 2005 forecast, released on 4 April, where real GDP growth is projected at 2.9% in 2005 and 3.1% in 2006. Consequently, based on the latest available information, including the current consensus, the Commission services consider this ‘alternative-2’ scenario, and not the baseline, as the most plausible macroeconomic outlook and use it as reference for assessing the programme.

The external assumptions attached to the reference scenario are formulated as risks to the assumptions underpinning the baseline. The risks essentially account for the current uncertainties in oil markets, a further appreciation of the euro and a possible deceleration of economic activity in the euro area. Although not fully spelled out in the programme the external assumptions attached to the reference scenario would seem to be comparable with those of the Commission services spring 2005 forecast.

The inflation outlook presented in the programme is almost identical across the three alternative scenarios in spite of significant differences in economic growth. Moreover, it would appear to be on the optimistic side for several reasons. First, the inflation outlook in the programme does not incorporate the effects of an increase in indirect taxation

foreseen in the additional fiscal measures announced on 29 March 2005. Second, the Commission services spring 2005 forecast assume a mild acceleration of inflation on the back of the persisting overhang of aggregate demand over supply and the recently negotiated strong wage increases, which are expected to carry over into the next few years.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		2005		2006		2007
	COM	**SP**	**COM**	**SP**	**COM**	**SP**	**SP**
Real GDP (% change)	**4.2**	**4.2**	**2.9**	**2.9**	**3.1**	**3.0**	**3.0**
Contributions:							
- Final domestic demand	**4.6**	**4.7**	**3.1**	**3.0**	**3.4**	**2.5**	**2.6**
- Change in inventories	**0.1**	**0.1**	**-0.1**	**-0.2**	**0.0**	**0.0**	**-0.1**
- External balance on g&s	**-0.5**	**-0.5**	**-0.2**	**0.1**	**-0.2**	**0.4**	**0.4**
Employment (% change)	**2.8**	**2.8**	**0.6**	**0.9**	**0.7**	**1.0**	**1.0**
Unemployment rate (%)	**11.0**	**11.0**	**11.2**	**11.0**	**11.0**	**10.8**	**10.4**
HICP inflation (%)	**3.0**	**3.0**	**3.2**	**2.9**	**3.2**	**2.8**	**2.7**
GDP deflator (% change)	**3.4**	**3.4**	**3.3**	**3.4**	**3.3**	**3.2**	**3.0**
Current account (% of GDP)	**-6.9**	**-7.0**	**-6.3**	**-6.1**	**-5.6**	**-5.3**	**-4.5**

Sources:
Commission services spring 2005 economic forecasts (COM); revised March 2005 update of the stability programme, 'alternative-2' scenario, (SP)

As to the medium term, the data of the reference scenario imply a rate of potential output growth which gradually eases over the programme period from around 3.3% in 2005 to 3% in 2007.[4] This is broadly in line with the estimates of the Commission services 2005 spring forecast which shows a slightly lower rate of potential output growth. The deceleration in the underlying rate of growth implied by the reference scenario is estimated to result from total factor productivity suggesting that the assumption for employment growth may be one the high side. The sizeable positive output gap recorded in 2004 is set to narrow somewhat up until 2007.

Table 2: Sources of potential output growth

	2004		2005		2006		2007
	COM	**SP[3]**	**COM**	**SP[3]**	**COM**	**SP[3]**	**SP[3]**
Potential GDP growth[1]	3.0	3.3	3.1	3.4	3.1	3.2	3.0
Contributions:							
- Labour	0.1	0.4	0.3	0.7	0.4	0.7	0.7
- Capital accumulation	1.5	1.5	1.5	1.5	1.5	1.4	1.4
- TFP	1.4	1.3	1.3	1.2	1.2	1.0	0.9
Output gap[1,2]	2.4	2.1	2.2	1.6	2.2	1.5	1.5

Notes:
[1]based on the production function method for calculating potential output growth
[2]in percent of potential GDP
[3]Commission services calculations on the basis of the information in the stability programme March 2005 update

Sources:
Commission services spring 2005 economic forecasts (COM); Commission services calculations

[4] Based on the Commission services calculations according to the commonly agreed methodology.

3. BUDGETARY IMPLEMENTATION IN 2004

According to the March 2005 EDP notification, the general government balance is estimated to have recorded a deficit of 6.1% of GDP in 2004 (6.0% on an ESA95 National Accounts basis). This deficit is 0.8 percentage points higher than the figure of 5.3% of GDP estimated by Greek government at the time of the September 2004 EDP notification. A part of the revision, 0.2 percentage point of higher interest payment, had already been anticipated in the Commission services autumn 2004 forecast.

Box 1: The 2004 vis-à-vis the 2003 updated stability programme

The difference in the deficit figures between the 2004 and 2003 updates is of almost 5 percentage points of GDP. The 2004 budget, approved by the Greek Parliament at the end of 2003, targeted a deficit of 1.2% of GDP. The Commission services' assessment of the 2003 updated stability programme, considered this figure as unrealistic and expected a worse outturn. At the time there were still uncertainties: (i) about the base-year effects on 2004 from the higher deficit in 2003; (ii) about the impact of the 2003 social package (estimated at over 1% of GDP for 2004); and (iii) on the official tax projections.

At the end March 2004 the new government carried out a revision of the budget and raised the deficit figure to 3% of GDP. Total revenues were revised downward by 0.7 percentage point of GDP and total expenditures were revised up by 1.2 percentage point of GDP.

The September EDP notification included a further revision of the deficit from 3% of GDP to 5.3% of GDP . The additional slippage was only partly explained by statistical revisions, which amounted to 1.1 percentage points of GDP. Expenditure overruns linked to the organisation of the Olympic Games account for 0.7 percentage point of GDP). Other expenditure overruns and revenue shortfalls amount to 0.5 percentage point of GDP.

The EDP March 2005 notification presents an additional slippage, which includes, besides the 0.3 percentage point of GDP in higher interest payments, other tax shortfalls and expenditure overruns worth half a point of GDP. The additional slippage is due to the central government, which posted a deficit of 9.3% of GDP, 1.4 percentage points of GDP higher than in the September notification.

Major factors determining the deficit outturn in 2004 compared with the initial target

	% of GDP
Original budget presented by the former government	**1.2**
Main corrections made by the new government before the end of March 2004	
Indirect taxes	+0.4
Social contributions	-1.1
Capital transfers received	+1.4
Consumption (of which public wages)	+0.8 (+0.5)
Social transfers	+0.4
End-March 2004 notification sent by the new government (1)	**3.0**
Statistical revisions (2)+(3)	
Social security funds (2)	+0.3
Military expenditures (3)	+0.8
Intermediate outturn (4)=(1)+(2)+(3)	**4.1**
Overruns linked to the organisation of the Olympic Games	+0.7
Other expenditure overruns and revenue shortfalls	+0.5
Notification September 2004 (5)	**5.3**
Higher interest payments	+0.3
Indirect taxes shortfalls	+0.1
Hospital debts assumptions	+0.1
Transfers to social security	+0.4
Notification March 2005	**6.1**

A '+' is deficit-increasing, a '–' deficit-decreasing

The budgetary slippages unveiled in the last two EDP notifications have taken place in spite of consolidation measures implemented by the government, which, according to the Greek authorities would have amounted to almost 0.7 percentage point of GDP. In spite of such measures, the fiscal effort defined as the change in the CAB, net of statistical revisions, would be negative by a figure close to 2% of GDP[5].

On 18 March 2005 Eurostat did not validate the deficit figures presented in the Greek reporting of deficit and debt levels of 1 March 2005 because of an inconsistent recording of flows between Greece and the EU budget. Eurostat also noted that healthcare -and Olympics- related expenditure for past years is not yet final. Therefore, the government deficit figures for 2004 and earlier years may have to be revised upwards.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Evolution of budgetary targets in successive programmes

Table 3 gives an overview of the evolution of budgetary targets in successive updates of the programme. As a result of the significant statistical revisions of the 1997-2003 general government data that took place during the last year, coupled with the large slippages recorded in 2004, the programme presents nominal deficit figures over 2003-2007 well above previous updates[6]. Specifically, for 2003 the difference of 3.8 pp of GDP between the new and the previous update is fully attributed to the statistical revisions of September 2004 coupled with some additional revisions (0.6 pp of GDP in national accounts terms) carried out in March 2005.

Graph 1 shows that medium-term fiscal targets have been permanently missed and that deep revisions of the adjustment path have taken place in subsequent updates. Since 1999, the actual budgetary outturn has constantly and significantly diverged from the path outlined in the successive programmes. This has been the result of optimistic macroeconomic scenarios and significant budgetary slippages. Only a part, and not the largest one, of the divergence in 2004 can be attributed to the effects of statistical revisions in previous years (see annex 3).

[5] Based on a projected 2004 deficit of 5.5% of GDP, the Commission recommendation for a Council decision under Article 104(8), establishing that Greece had not taken effective action in response to the Council recommendations under Article 104(7), estimated the fiscal effort, net of statistical revisions, at -1.4 percentage points of GDP.

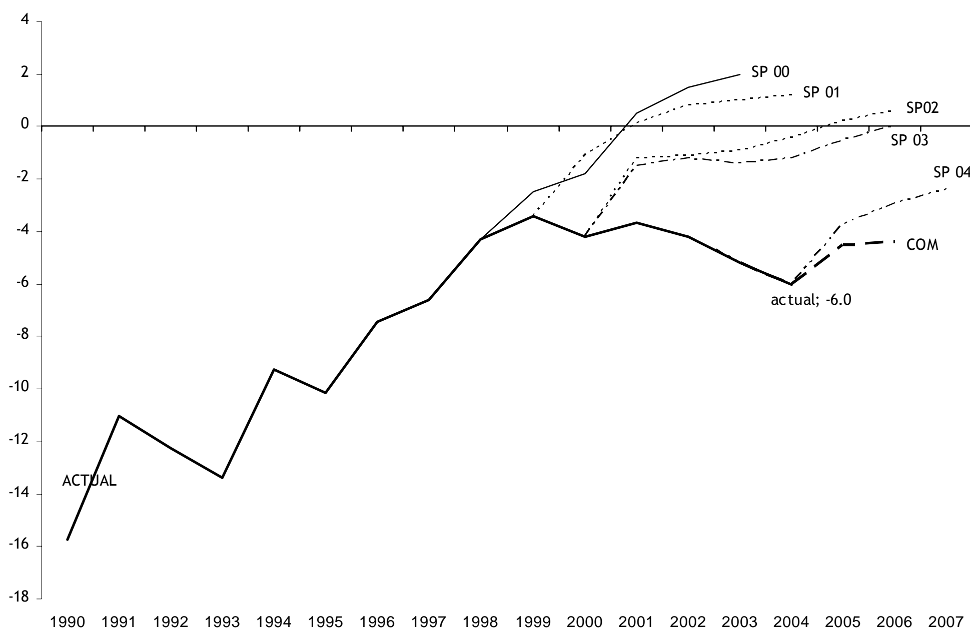
[6] Specifically, 2003 the difference between the new and the previous update (3.2% of GDP) is fully attributed to the statistical revisions of September 2004.

Table 3: Evolution of budgetary targets in successive programmes

		2003	2004	2005	2006	2007
General government balance (% of GDP)	**SP 2004**	**-5.2**	**-6.1**	**-3.7**	**-2.9**	**-2.4**
	SP 2003	-1.4	-1.2	-0.5	0.0	n.a.
	SP 2002	-0.9	-0.4	0.2	0.6	n.a.
General government expenditure (% of GDP)	**SP 2004**	**48.6**	**50.4**	**49.1**	**49.0**	**49.2**
	SP 2003	45.2	45.0	44.2	43.5	n.a.
	SP 2002	46.0	44.9	44.2	43.8	n.a.
General government revenues (% of GDP)	**SP 2004**	**43.4**	**44.4**	**45.4**	**46.1**	**46.7**
	SP 2003	43.7	43.7	43.7	43.5	n.a.
	SP 2002	45.1	44.5	44.4	44.3	n.a.
Real GDP (% change)	**SP 2004**	**4.7**	**4.2**	**2.9**	**3.0**	**3.0**
	SP 2003	4.0	4.2	4.0	3.8	n.a.
	SP 2002	3.8	4.0	3.7	3.6	n.a.

Sources:
Stability programme March update 2005 (SP)

Graph 1: Evolution general government balances in successive programmes



Box 2: The excessive deficit procedure for Greece

The Council, upon the corresponding Commission recommendations, placed Greece in excessive deficit on 5 July 2004 and, according to Article 104(7) of the Treaty, addressed recommendations to Greece with a view to bringing the excessive deficit situation to an end by 2005. On 18 January, the Council decided in accordance with Art 104(8) of the Treaty that Greece had not taken effective action in response to these recommendations. On 17 February, also upon a Commission recommendation in accordance with Article 107(9), the Council decided to give notice to Greece to take measures for the deficit reduction judged necessary to remedy the situation. The Council established the deadline of 21 March 2005 for Greece to take effective action to comply with this Decision. Specifically, the Council decided that '*Greece shall put an end to the present excessive deficit situation as rapidly as possible and the latest by 2006 through: (i) a rigorous implementation of the 2005 budget as approved by its Parliament, and (ii) implementing in 2006 adjustment measures of a permanent nature leading to a correction in the deficit of at least 0.6 percentage point of GDP'*. The Council also required Greece to further pursue the efforts to *'identify and control factors other than net borrowing, which contribute to the change in debt levels'* and *'to improve the collection and processing of general government data'*. The Council urged *'Greece to take the necessary measures to ensure that budgetary consolidation towards the medium term position of government finances close to balance or in surplus is sustained through a reduction in the cyclically-adjusted deficit by at least 0.5% of GDP per year after the excessive deficit has been corrected'*. Finally, the Council required Greece to *'submit, by 21 March 2005 at the latest, a report outlining the decisions to respect the recommendations of this Decision'*.

The Commission adopted on 6 April 2005 a Communication to the Council assessing compliance of measures implemented or announced in response to the Council decision under Article 104(9). The Commission concludes that the Greek government has taken effective action, by the deadline of 21 March, in response to the Council notice in accordance with Article 104(9). Specifically, besides implementing with rigour the 2005 budget, as required by the decision, the government has also announced additional measures to reduce the deficit further. As to 2006, information provided indicates that the implementation of additional measures may be needed within the 2006 budget to bring the deficit below the 3% of GDP. However, the government's commitment made public on 29 March, to ensure the correction of the excessive deficit by 2006 if necessary by undertaking additional measures, is in line with the recommendations of the Council. Where debt developments and general government data are concerned, additional efforts appear necessary to better identify and control the factors, other than net borrowing, that contribute to the change in debt levels and to improve the collection and processing of general government data. Based on this assessment, no further steps in the excessive deficit procedure of Greece are needed at present. On the basis of the report to be presented in October 2005 by the Greek authorities, as foreseen in the Council decision, the Commission will carry out a new assessment of compliance before the end of the year.

4.2. Budgetary targets in the updated programme

The reference scenario targets a reduction of the nominal general government budget deficit by 3.6 percentage point over the programme period, from the outturn of 6.0% of GDP in 2004 to 2.4% in 2007. The fiscal correction is frontloaded, both in nominal and cyclically adjusted-terms, and concentrated in 2005 and, to a lesser extent in 2006, while in 2007 the adjustment amounts to just 0.5 percentage points of GDP. The strategy aims at reducing the deficit to below the 3% of GDP reference value by 2006, in line with the Council decision under Article 104(9). The fiscal strategy to achieve the above goals is a mix of revenue-enhancing measures and expenditure retrenchment, which aims at maintaining high primary surpluses. The primary balance is projected to improve from a deficit of 0.4% in 2004 to a surplus of 1.8% of GDP in 2005 that increases up to 3.3% of

GDP at the end of the period. According to the programme, the fiscal measures also aim at providing incentives for higher profitability, higher investment activity and enhanced growth.

The deficit targets of the reference scenario compare with a more prudent projection in the Commission services spring 2005 forecast, which expects deficits of 4.5% of GDP in 2005 and of 4.4% of GDP in 2006. Leaving aside a more cautious assessment of some tax and expenditure items referred to below, a significant part of the difference is explained by the additional fiscal measures for 2005 and 2006, presented in 29 March 2005, which were announced after the cut-off date of the Commission forecasts. Consequently, under the customary no-policy-change rule, which excludes the consideration of non-publicly announced measures, the Commission services could only consider the measures included in the official 2005 budget.

According to the programme, complemented by the additional measures announced on 29 March 2005, the corrective measures for 2005 add up to 2½ percentage points of GDP. They include both expenditure reductions and revenue increases. Box 3 describes the budgetary measures in the 2005 budget in detail, as well as the additional measures outlined by the government on 29 March 2005. Total revenues are expected to increase from 44.4% of GDP in 2004 to 45.4% in 2005 on the back of two main measures. First, the tax settlement (law 3259/2004) is expected to bring additional proceeds worth of 0.3 percentage point of GDP. Second, the VAT rate increase of 1 percentage point, coupled with the rise of tobacco and alcohol duties, is projected to give around 0.5 percentage point of GDP. On top of this, although no reform has been announced, social security contributions are expected to increase by another half percentage point of GDP, while corporate taxes are set to remain on a downward trend. The tax burden is expected to increase further, up to 46.1 % of GDP, because of the carryover effects of the VAT and duties increase and of still dynamic social security contributions. In 2007, a further increase of 0.6 pp of GDP is projected, which also seems to come from the increase in social security contributions relative to GDP.

In addition to the increase in indirect tax rates and duties, consolidation in 2005 is mainly achieved through a fall in the expenditure-to-GDP ratio, which is expected to decline by 1.3 pp (from 50.4% of GDP in 2004 to 49.1% in 2005). The largest reduction in the expenditure ratio stems from public investment expenditure, which after the completion of the Olympic Games will be reduced by 0.8 pp of GDP. Government consumption is also expected to decrease by 0.3 pp of GDP. An increase of transfers and subsidies of 0.9 should be offset by a comparable reduction of other expenditure (current and capital). Expenditures in the debt servicing payments will also be lower by 0.2% of GDP. Overall, the primary surplus will increase to 2.6% of GDP as compared to a projected deficit of 0.4% for 2004. In 2006, consolidation on the expenditure side becomes less pronounced. While total expenditures should remain almost unchanged, primary expenditures are projected to decline by only 0.3 percentage point of GDP. In spite of the announced cut in subsidies, public wages seem to be the only source of saving, while transfers and subsidies would grow by almost 1 percentage point of GDP. In 2007, albeit by a small amount (0.2 pp of GDP), total expenditures are projected to increase, mainly because a further rise of transfers only partially offset by savings in public consumption.

After the strong decline recorded in 2005, the public investment ratio is expected to fall slightly by 0.1 pp of GDP each year, and go marginally below 3%, a figure still higher than in the EU average.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003	2004	2005	2006	2007	Change: 2007-2004
Revenues	43.4	44.4	45.4	46.1	46.7	**2.3**
of which:						
- Taxes & social security contributions	39.0	39.5	40.6	41.5	42.2	**1.6**
- Other (residual)	4.4	4.9	4.8	4.6	4.5	**-0.4**
Expenditure	48.6	50.4	49.1	49.0	49.2	**-1.2**
of which:						
- Primary expenditure	42.8	44.8	43.7	43.4	43.5	**-1.3**
of which:						
Gross fixed capital formation	4.0	4.1	3.3	3.1	2.9	**-1.2**
Consumption	16.4	17.1	16.8	16.0	15.4	**-1.7**
Transfers & subsidies	17.8	18.7	19.6	20.5	21.6	**2.9**
Other (residual)	4.6	4.9	4.0	3.8	3.6	**-1.3**
- Interest payments	5.8	5.8	5.4	5.6	5.7	**0.1**
Budget balance	**-5.2**	**-6.1**	**-3.7**	**-2.9**	**-2.4**	**3.6**
Primary balance	**0.6**	**-0.4**	**1.8**	**2.7**	**3.3**	**3.7**

Sources:
Stability programme March 2005 update; Commission services calculations

There are negative risks to the budgetary outlook for 2005 and beyond both on the revenues and expenditure side. As the macroeconomic outlook of the reference scenario is essentially in line with the Commission services spring 2005 forecast, the risks should not be linked to economic growth. They rather refer to somewhat optimistic projections of certain budgetary items. Taking at face value the information provided by the Greek government, the full implementation of the additional measures announced on 29 March 2005 would lead to an improvement of the projected deficit of around 0.5 percentage points of GDP in 2005. However, according to the Commission services spring 2005 forecast, these additional measures, on top of those in the official 2005 budget, would not result in a deficit of 3.7% of GDP, but of around 4% of GDP. On the one hand, the official projection for social security contributions appears on the high side. Specifically, the programme projects a strong increase in social securities contributions vis-à-vis compensation of employees in 2005, which seems unwarranted based on past trends. On the other hand, also considering past trends the programme projections of public consumption, especially health care and wages, appear optimistic.

The remaining gap of 0.3% of GDP between the updated stability programme including the additional measures announced on 29 March 2005 and the Commission services spring 2005 forecast may affect the effective action to be taken to reduce the deficit below 3% in 2006.

According to the Commission spring 2005 forecast, a no-policy change scenario would turn out in a deficit of 4.4% of GDP in 2006, only marginally lower than in 2005 due to the expected measured acceleration in economic growth. On this basis, the measures announced for 2006 of 1 percentage point of GDP, should they be confirmed in the 2006 budget, would reduce the deficit to 3.4% of GDP. The difference of half a point vis-à-vis the target in the reference scenario has its origin in three budget items. First, the programme keeps on projecting a very strong increase in social security contributions vis-à-vis compensation of employees, which, as in 2005, would not seem to be realistic. Second, the planned large retrenchment in wages would seem to be very ambitious. Third, given past trends, EU grants might also be overestimated. Hence, on balance, risks to budgetary outlook are clearly skewed to the downside. Should such more prudent assessment materialise, the Greek authorities would need to implement additional measures in 2006, on top of those already announced, to effectively bring the deficit below the 3% threshold.

Box 3: The budget for 2005

The 2005 State Budget, adopted by the Parliament on 22 December 2004, provides for a general government deficit of 2.8% of GDP from 5.3% in 2004. The largest part of this reduction of 2.5 pp pertains to the central government deficit (2.1 percentage points-down from 6.9% to 4.8% of GDP). The fiscal strategy to pursue this goal is based on maintaining high primary surpluses, consistent with the reduction of the expenditure ratio and the increase in current revenues, mostly through incentives for higher profitability, higher investment activity and enhanced growth. The policy measures included in the 2005 State Budget are the following: a permanent reduction of expenditure following the completion of the Olympic Games, a reduction in grants in the investment budget, moderate increases in wage and pensions, an extremely restrictive hiring policy in the public sector, and nominal reductions by 6.5% in current operating expenditure.

In the framework of the new tax reform the government announced an increase of non-taxed income for certain categories of employees, reinstruction of tax brackets, streamline of the existing system of tax exceptions, a gradual reduction of corporate tax rates from 35% to 25% within the next three years, a simplification of the tax audit procedure which will be rendered more transparent. Another important measure is linked to the implementation of the law 3259/2004, providing for a tax settlement (including delinquent obligations to the state, repatriation of capital and unsettled tax accounts for professionals and enterprises). For 2005, the impact of this measure is an increase in revenues by 0.35% of GDP. In order to increase further public revenues, the government replaced the Financial Crimes Squad (SDOE) with a new organisation which will focus on investigating tax evasion, illegal trade and financial crime.

The 2005 State Budget plans a primary surplus of 2.2% of GDP as compared to a balance in 2004. According to the State Budget, in 2005 public debt will reach 109.5% of GDP (112.1% in 2004).

On 29 March 2005 the government announced a package of additional measures involving an increase of the average VAT rate by 1 percentage point in 2005, which is assessed to provide additional revenues of €610 millions, together with an increase in tobacco, alcohol and oil products duties, which should amount to €280 millions. The package also includes savings on travel expenses of civil servants (€45 millions) and the reduction in subsidies to urban transport companies (€50 millions). Overall, if fully implemented, the package should lead to a deficit reduction of €985 millions -0.5% of GDP[1]- in 2005.

Table 5 compares the estimates of output gaps and cyclically-adjusted balances derived from the programme using the commonly agreed methodology with the Commission spring 2005 forecast. Based on Commission services calculations according to the commonly agreed methodology applied to the reference scenario to assess the programme, the cyclically-adjusted deficit would fall from 7.0% of GDP in 2004 to 4.4% of GDP in 2005, to 3.5% of GDP in 2006, and 3% in 2007. This confirms that the adjustment is concentrated in 2005 (2.5 pp) and, to a lesser extent, in 2006 (0.9 pp), while the cyclically-adjusted deficit is reduced by the minimum half a point of GDP in 2007. The difference between the cyclically-adjusted budget balances derived from the reference scenario of the programme and those in the Commission services spring 2005 forecast is largely explained by (i) the additional measures for 2005 and 2006 announced on 29 March 2005, i.e. after the cut-off date of the forecast and (ii) a lower Commission estimate of potential output reflecting a more cautious assessment of labour market developments.

Table 5: Output gaps and cyclically-adjusted (primary) balances (CA(P)B)[4]

	2004		2005		2006		2007	Change: 2007-2004
	COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]
Budget balance[2]	-6.1	-6.1	-4.5	-3.7	-4.4	-2.9	-2.4	3.6
Output gap[1,3]	2.4	2.1	2.2	1.6	2.2	1.5	1.5	-0.6
CAB[1,2]	-7.1	-7.0	-5.5	-4.4	-5.3	-3.5	-3.0	-3.9
CAPB[1,2]	-1.4	-1.3	0.0	1.0	0.1	2.1	2.6	3.9

Notes:
[1]Commission services calculations on the basis of the information in the programme
[2]in percent of GDP
[3]in percent of potential GDP
Sources:
Commission services Spring 2005 economic forecasts (COM); Commission services calculations

As a final point, the reference scenario of the programme does not ensure a close-to-balance or in surplus position throughout the programme period. This contrasts with the country specific Broad Economic Policy Guidelines in the area of public finance for the 2003-2005 period. Moreover, in view of the sizeable positive output gap, the cyclically-adjusted deficit stays consistently above or at 3% of GDP, implying obviously that the budgetary strategy outlined in the reference scenario does not provide enough safety margin to breach the 3% of GDP threshold in case of a normal cyclical downturn.

4.3. Sensitivity analysis

As mentioned before, the programme presents three different scenarios underpinned by three different growth projections. However, in spite of the significant divergence in terms of economic growth, the deficit paths are almost unaffected. Specifically, the deficit is always expected to fall below the 3% of GDP reference value in 2006 irrespective of growth. While this presentation may reflect the political commitment to comply with the Council recommendation under Article 104 (9), it does not allow for a genuine risk assessment concerning the effects of higher or lower growth. In particular, it does not disentangle the change in the budget balance resulting from variations in growth from the discretionary policy measures aimed at keeping the deficit on track.

A simulation carried out by the Commission services allows for a more relevant sensitivity analysis. Assuming (i) a sustained 0.5 percentage point deviation from the growth targets in the programme over the 2005-2007 period; (ii) trend output based on the HP-filter; and (iii) no policy response i.e. notably, the expenditure level is as in the central scenario the simulation reveals that by 2007, in the case of persistently lower growth, the cyclically-adjusted budget deficit would be around 0.8 percentage point higher than in the central scenario. Hence, additional measures of that size would be necessary to keep the public finances on the path targeted in the reference scenario.

5. EVOLUTION OF THE DEBT RATIO

Table 6 describes the evolution of the debt ratio and its determinants. According to the programme, in the reference scenario, the debt ratio is projected to decline from 110.5% of GDP in 2004 to only 109.5% in 2005 and then to 107.2% in 2006 and 104.7% in 2007.

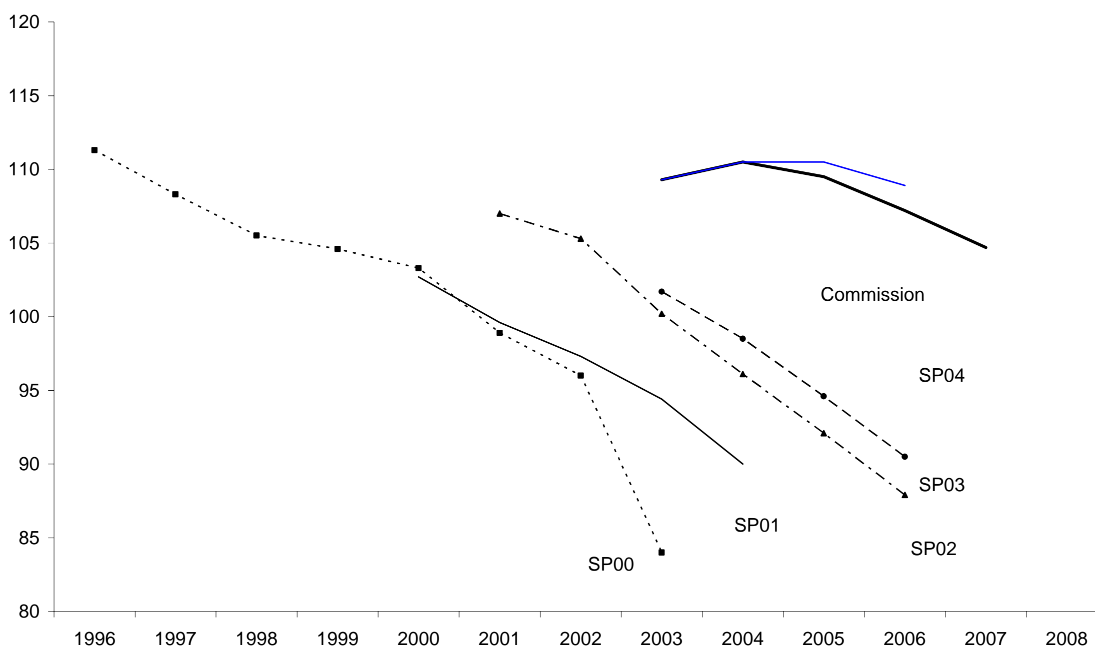
The estimated outcome for 2004 in the programme sharply contrasts with the projected figure of 98.5% in the 2003 update. This difference is the result of several factors: statistical revisions, budgetary slippages, and differences in the corresponding stock-flow adjustment. As shown in the Annex, statistical revisions in Greece have led the debt ratio

to increase by 7.7 percentage points of GDP on average each year during the period 2000-2003 and by 12 percentage points of GDP in 2004.

From 2005 onwards, the primary surplus and high nominal GDP growth would be the main driving forces behind the projected path of debt-reduction. A faster pace of debt reduction is hampered by significant debt increasing stock-flow adjustments (SFA), which, while declining compared to 2004, are expected to remain significant in spite of planned privatisation proceeds. The programme provides a detailed account of the operations behind the SFA in 2004. Specifically, the update refers to an increase in deposits, differences between cash and accrual revenues and an increase in shares. Therefore, it seems that some progress have been made to identify the sources of the SFA. However, the programme does not provide details on the origin of the projected SFA over 2005-2007.

Compared with the Commission services spring 2005 forecasts, debt developments in the programme appear relatively optimistic. Specifically, the higher deficit projection and somewhat lower nominal growth featured in the Commission's outlook imply an unchanged level of the debt level in percent of GDP in 2006 and a smaller reduction in 2006. As mentioned before, the Commission 2005 spring forecast does not include the additional measures announced on 29 March 2005. Allowing for those additional measures would accelerate debt reduction but the level would still be somewhat higher than in the programme.

Graph 2: Evolution general government debt in successive programmes



Like the deficit paths, debt targets in the various updates have consistently been missed by a large margin. The systematic divergence from plans is explained by (i) direct revisions of the debt level; (ii) the downward revision of the primary surplus from one update to the following; (iii) lower than projected nominal growth; and (iii) the effects of significant below-the-line financial operations not taken into account in the medium-term projections of the updates.

A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in graph 3. It compares the projections for the debt ratio in each year of the programme (starting from the projection for 2004) with the values obtained for the same

year by applying an illustrative "rolling debt reduction rule". This rule describes a minimum reduction in the debt ratio over the previous five/four/three-year period; for example, the projection for 2004 is compared with the values obtained for the same year by applying the formula over the periods 1999-2004, 2000-2004 and 2001-2004. If the debt levels projected in the programme exceed those obtained by applying the rule, this is taken as an indicator of a slow reduction in the debt ratio. This is consistent with the idea that the minimum debt reduction should be ensured not year after year but over a medium-term horizon. Graph 3 shows that according to the planned path of debt reduction falls clearly short of the one implied by the rolling debt reduction rule.

Table 6: Debt dynamics

	average 2000-2003	2004		2005		2006		2007	2008
	COM	COM	SP/CP	COM	SP/CP	COM	SP/CP	SP/CP	SP/CP
Government gross debt ratio	**112.6**	**110.5**	**110.5**	**110.5**	**109.5**	**108.9**	**107.2**	**104.7**	
Change in debt ratio (1 = 2+3+4)	-0.7	1.2	1.2	-0.1	-1.0	-1.6	-2.3	-2.5	
Contributions:									
- **Primary balance** (2)	**-2.7**	**0.4**	**0.4**	**-0.9**	**-1.7**	**-1.2**	**-2.7**	**-3.3**	
- **"Snow-ball" effect** (3)	**-1.5**	**-2.2**	**-2.2**	**-1.1**	**-1.2**	**-1.1**	**-0.8**	**-0.4**	
- Interest expenditure	6.9	5.6	5.6	5.5	5.4	5.6	5.6	5.7	
- Real GDP growth	-4.5	-4.2	-4.2	-3.0	-3.0	-3.2	-3.1	-3.0	
- Inflation (GDP deflator)	-3.9	-3.6	-3.6	-3.5	-3.6	-3.5	-3.3	-3.0	
- **Stock-flow adjustment** (4)	**3.4**	**3.0**	**3.0**	**1.9**	**1.9**	**0.7**	**1.2**	**1.2**	
- Cash/accruals	1.7								
- Accumulation of financial assets	0.9								
of which: Privatisation proceeds	-0.7	-0.5	-0.5		-0.6		-0.3	-0.1	
- Valuation effects & residual adj.	0.8								

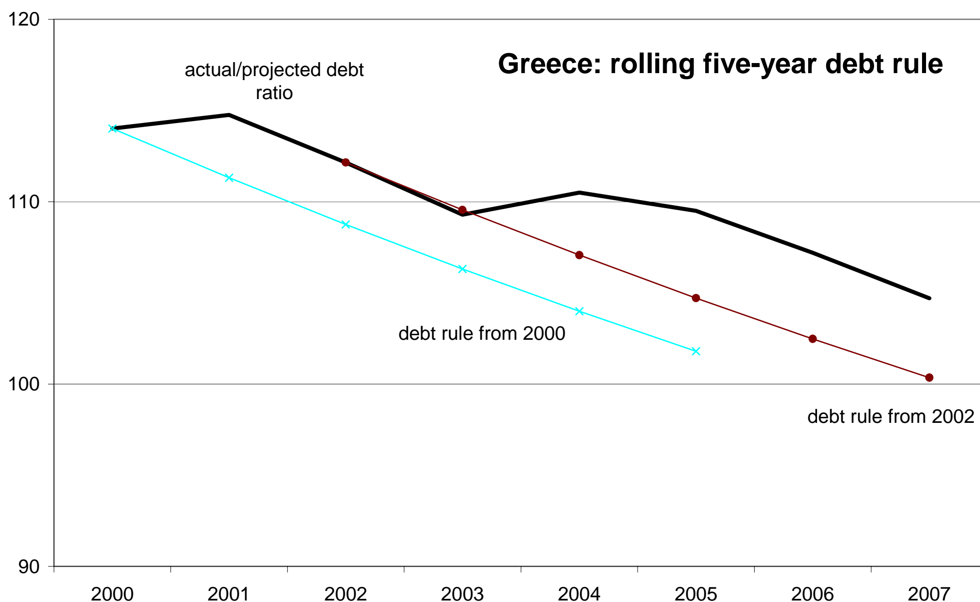
Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t}\right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

Sources:
Stability/Convergence programme update (SP/CP); Commission services Spring 2005 economic forecasts (COM); ECFIN calculations

Graph 3: Rolling five-year debt rule



6. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

According to the programme, the change in the composition of expenditures and its re-orientation towards more productive uses is high in the political agenda of the Greek Government. The 2005 budget contemplates a reduction operating expenditures (intermediate consumption) in nominal terms. Such a target would appear ambitious since they assume significant cuts in components of the budget, which have traditionally exhibited quite strong upward trends.

The government also plans to set up an Independent Body of Fiscal Inspectors, which would reinforce the fiscal auditing system, which is also foreseen to be reinforced on the revenues side. The tax reform envisages a more transparent control system for professionals and enterprises. While pointing into the right direction, the programme only provides a brief outline of the initiatives excluding a conclusive assessment.

On health-care, the government is preparing a reform aiming at ensuring financial sustainability and addressing some weaknesses. In the short run, the most pressing problem is the accumulation of debt from hospital suppliers. It appears that the government is planning to restructure the current debt and would like to put in place measures preventing its reoccurrence in the future. The reform also includes measures to control health-care costs in the medium and long term, which contemplate, among other measures, the recourse to Private-Public-Partnerships. However, the programme does not give details on how the hospitals' debt will be restructured and the plans for a far-reaching reform are still in a very preliminary stage and have not been yet submitted for public consultation.

Other axes of the structural reforms in Greece will aim at reducing business start-ups costs and at further opening markets for competition, especially network industries.

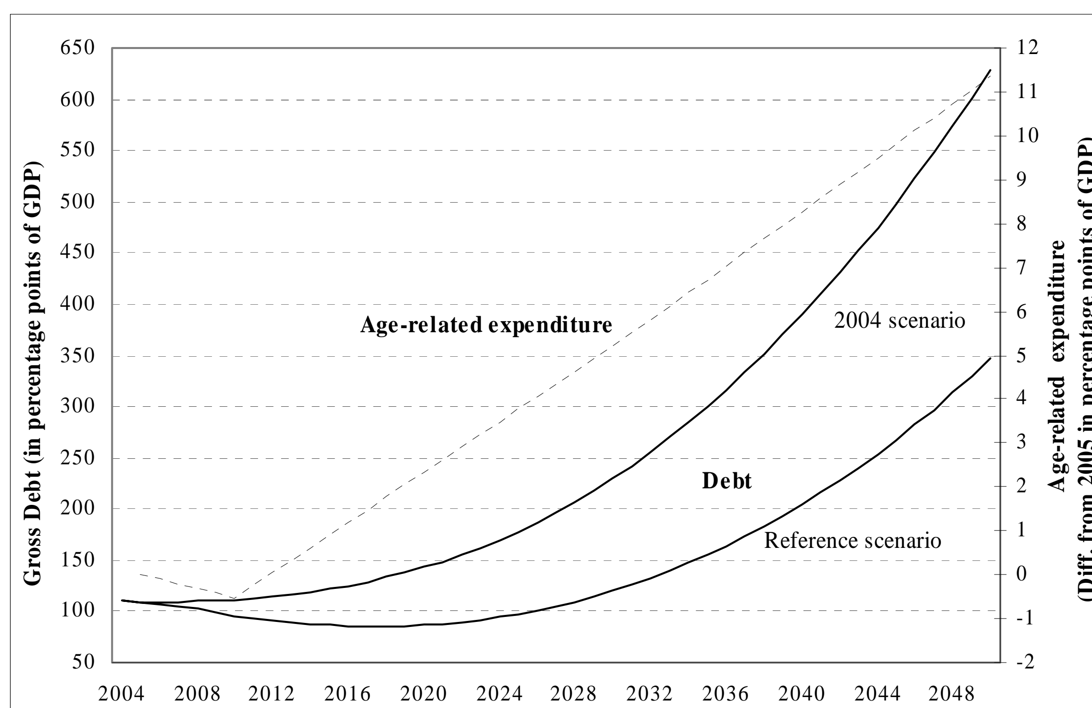
7. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Greek public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The

quantitative indicators project debt development according to two different scenarios, to take into account different budgetary developments over the medium term. The reference scenario assumes that the medium-term objective set up in the programme is actually achieved, while the "2004" scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

The graph below presents the gross debt development according to the two different scenarios. On the basis of the reference scenario and additional information provided by the EPC, age-related expenditure is foreseen to increase by 11.7% of GDP between 2008 and 2050 (see annex for a breakdown of different age-related expenditures). Gross debt, remaining above 100% of GDP during the programme period, is projected to slightly decline over the coming 15 years if the planned consolidation takes place.

Long-term sustainability: summary results



Sustainability indicators

	S1*	S2**	RPB***
Reference scenario	4.0	6.5	9.3
2004 scenario	7.9	10.4	9.4

Notes:
* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.
** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: -118%
*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically-adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the intertemporal budget constraint of the government for this period.

However, the debt dynamics would become unfavourable once the considerable cost of ageing kicks in. If the budgetary consolidation plans in the medium-term do not materialise, an even more accentuated explosive gross debt path would emerge[7].

[7] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value.

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance in order to have a debt to GDP ratio in line with the Maastricht Treaty reference value in the very long run (year 2050)[8]. S2 shows the gap between the current tax policies and those that would ensure respect of the intertemporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to the latter, in order to tackle the cost of ageing entirely through a budgetary strategy Greece should increase its tax ratio permanently by 6.5 percentage points compared with the projected one at the end of the programme period. This would lead to a negative sustainable debt ratio by the middle of the century[9]. The budgetary effort over the first 5 years of projections (i.e. after the end of the programme period) to respect the intertemporal budget constraint requires a primary surplus of 9.3% of GDP on average, considerably higher than targeted for the last year of the programme period (measured in underlying terms).

In interpreting these results, several factors must be taken into account.

First, Greece has not yet taken drastic measures in reforming its public pay-as-you go pension system, while experiencing a sharp deterioration in its dependency ratio. Law 3029/2002 provides for the establishment of a second pillar in the Greek pension system by the creation of fully funded auxiliary funds labelled as occupational funds and acting as private entities. Implementation of these measures has started on a slow pace with only three funds created up to now. It seems that a lack of political willingness in combination with the promotion of early retirement in particular in the public sector, has contributed to the slow pace of implementation of the necessary measures to fully develop the second pillar of the pension system and to control public pension expenditures.

Second, the unemployment rate is projected to be halved in 2050 compared with 2000. This is based on rather optimistic assumptions on growing investments and employment as the result of an economic and political stability in the future and less rigidities in the labour market. The increase in the participation rate of women by 9 percentage points is also rather optimistic, given that today the situation in Greece is characterised by women's limited participation in the labour market, owing to specific social preferences and to the insufficiency of social infrastructure. Several measures have been undertaken recently to promote active labour market policies in particular for women (Law 3250/2004 and the "Equal" programme financed by EU grants). However, there is not yet clear evidence as to the effectiveness of these measures. Where the impact of social security balances is concerned, the projected increase in women's participation is expected to boost social contributions. However, if the pension system fails to adopt a more balanced approach between contributions and benefits, the increase in expenditure at a later stage will counterbalance the revenue increase.

On the whole, with regard to the long-term sustainability of the public finances, Greece appears to be at serious risk on grounds of the large projected budgetary cost of an ageing

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[8] The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible imbalances after the end of the projection period.

[9] The debt ratio of around -118% in 2050 according to the S2 indicator illustrates that the sustainability gap is higher in order to ensure a sustainable evolution of gross debt beyond 2050, compared with the S1 indicator, which illustrates that a lower budgetary consolidation effort is compatible with the 60% reference value in 2050.

population. The considerable increase projected in age-related spending suggests that additional measures to control public pension expenditures, including the resolute implementation of reform measures enacted, are necessary.

The strategy outlined in the programme is mainly based on the implementation of legislated pension reforms and the necessary consolidation of public finances in the medium-term. Nevertheless, the gross debt-to-GDP, while projected to fall, remains above 100% of GDP throughout the programme period. Even if the planned budgetary consolidation should materialise over the programme period, a considerable sustainability gap emerges, pointing to the need for a broad-based approach to ensure the sustainability of the public finances. These results show that a strategy based exclusively on fiscal consolidation does not seem to be feasible.

Annex 1: Revision of the Greek government deficit and debt figures

On September 2004, the Greek authorities sent the customary EDP notification. As expected, this notification presented new and revised data compared to that notified in March, which indicated that Greece had been in excessive deficit since 2000. In particular (see tables below), the general government deficits notified to the Commission for 2000, 2001, 2002 and 2003 were revised upwards by more than two percentage points of GDP each year. The debt figures had also been revised upwards by more than 7 percentage points of GDP over the period of the notification (7.9 in 2000, 8.1 in 2001, 7.9 in 2002 and 7.3 in 2003). The projected figures for 2004 implied an upwards revision of the deficit and debt figures by 2.3% and 14% of GDP respectively.

This government data revision was carried out on the basis of new information provided by the Greek authorities, at the request of Eurostat, for the period 2000-2003, and rest on a more faithful application of the ESA95. After scrutinising the new data, Eurostat validated the new 2000-2003 figures on 23 September 2004. In response to a request by the Council, Eurostat also revised the accounts for years 1997, 1998 and 1999. In its report of 22 November on the 'Revision of the Greek government deficit and debt figures', the Commission concluded that the actual deficits in those years had also been well above 3% (Commission Communication 'Report on the accountability issue related to the revision of Greek budgetary data' COM(2004)784 of 1 December 2004).

Table A1. Statistical revisions of deficit figures (% of GDP), 2000-2004

In % of GDP	**2000**	**2001**	**2002**	**2003**	**2004**
2003 update SGP		-1.5	-1.2	-1.4	-1.2
1 March 04	-2.0	-1.4	-1.4	-1.7	-1.2
Tax revenue; VAT				*0.9*	
EU grants				*0.3*	
30 March 04	-2.0	-1.4	-1.4	-2.95	-2.92
Postal bank				*0.2*	
4 May 04	-2.0	-1.4	-1.4	-3.18	-2.92
Military expenditures	*1.9*	*1.2*	*1.7*	*0.7*	
Surplus of SSF	*0.0*	*1.0*	*0.4*	*0.6*	
Under recording interest	*0.3*	*0.1*	*0.1*	*0.1*	
1 September 04	-4.1	-3.7	-3.7	-4.6	-5.3
1 March 05	-4.1	-3.6	-4.1	-5.2	-6.1

The principal elements explaining the revision of the Greek deficit between March 2004 and September 2004 notifications are the following:

- Under-recording of military expenditures between 2000 and 2003. Data linked to payments for military equipment is now recorded on a cash basis. This results in the increase of the deficit by 1.9% of GDP in 2000, 1.2% in 2001, 1.7% in 2002 and 0.7% in 2003;
- Under-recording of capitalised interest between 2000 and 2003. The impact of inclusion of capitalised interest in government deficit is 0.3% of GDP in 2000, and 0.1% in 2001, 2002 and 2003;

- Over-estimation of surpluses of social security funds between 2001 and 2003. These revisions increase the deficit by 1.0% of GDP in 2001, 0.4% in 2002 and 0.6% in 2003;
- Downward revision for 2003 of VAT revenues (0.9% of GDP);
- Downward revision for 2003 of a payments received from EU institutions in the context of certain structural fund programmes (0.3% of GDP);
- Reclassification for 2003 of a payment from the postal saving bank to government as a financial transaction (0.2% of GDP);

Table A2. Statistical revisions of debt figures 2000-2004

In % of GDP	**2000**	**2001**	**2002**	**2003**	**2004**
2003 update SGP		106.9	104.7	101.7	98.5
1 March 04	106.2	106.9	104.7	102.4	97.7
4 May 04				103.0	98.3
Capitalised interest	*4.5*	*4.2*	*3.9*	*3.4*	
Consolidated assets of social security	*3.2*	*3.8*	*3.8*	*3.7*	
Mutual funds	*0.1*	*0.1*	*0.2*	*0.1*	
1 September 04	114.0	114.7	112.5	109.9	112.1
1 March 05	114.0	114.8	112.2	109.3	110.5

The origins of the revisions of debt figures were:

- the inclusion of the stock of capitalised interest in government debt (4.5% of GDP in 2000, 4.2% in 2001, 3.9% in 2002 and 3.4% in 2003), which had been previously erroneously excluded;
- a correct consolidation of assets of social security (3.2% of GDP in 2000, 3.8% in 2001 and 2002, and 3.7% in 2003);
- the inclusion of some mutual funds inside the government debt which was wrongly classified outside government in the period 2000-2003 (0.1% of GDP in 2000, 2001and 2003 and 0.2% in 2002);

According to the information provided by the Greek authorities, figures for deficit and debts covering the period 1997-1999 would increase due to:

- Increase of recording for military expenditures. This results in the deterioration of the deficit in 1997 by 0.15% of GDP, 0.07% in 1998, and 0.86% in 1999;
- Debt assumptions. The correction of incomplete data on debt assumptions leads to the increase of the deficit by 0.13% of GDP in 1997 and 1998 and by 0.09% of GDP in 1999.
- Capitalised interest. The recording of capitalised interest in the government expenditures deteriorates the deficit in 1997 by 1.02% of GDP, 0.27% in 1998 and by 0.10% in 1999.
- Capital injections. After correct recording, that deficit impact is 0.85% of GDP in 1997, 0.97% in 1998 and 0.73% in 1999.

- Interest on convertible bonds. The new figures, as provided by the Greek authoritiesincrease the deficit by 0.01% of GDP in 1998 and by 0.03% in 1999.
- DEKA. The reclassification of DEKA also increases the deficit by 0.22% of GDP in 1997, 0.20% in 1998 and 0.10% in 1999.
- EU grants. New data provided by the Greek authorities would result in the increase of the deficit by 0.21% and 0.17% of GDP in 1997 and 1998 respectively. However, the deficit in 1999 falls by 0.24% of GDP.
- Finally, the general government debt increases by 5.83 % of GDP in 1997, 6.59% in 1998 and by 7.07% in 1999. This is partly due to the inclusion of the stock of capitalised interest in government debt (4.85% of GDP in1997, 4.73% in 1998 and 4.53% in 1999), which had been erroneously excluded, and partly to the correct consolidation of assets of social security funds (0.98% of GDP in 1997 and, 1.86% in 1998 and in 1999).

Table A3. Statistical revisions deficit and debt figures (% of GDP), 1997-1999

	Deficit			**Debt**		
	1997	**1998**	**1999**	**1997**	**1998**	**1999**
Before the revisions	4.0	2.5	1.8	108.2	105.8	105.2
After the revisions*	6.6	4.3	3.4	114.0	112.4	112.3

*Based on a conclusion derived between Eurostat and the Greek authorities on 10th November 2004.

On March 2005, the Greek authorities sent the customary EDP notification. This notification presented new and revised data compared to that notified in September 2004. In particular, the general government deficits notified to the Commission for 2001 was revised downwards by 0.1 pp, while the government deficits for 2002, 2003 and 2004 were revised upwards to 4.1% of GDP, 5.2% and 6.1% respectively. The main reason for this revision, in particular for 2002 and 2003, was due to the fact that the expenditure of hospitals for past years was allegedly recorded on a cash basis and not on an accrual basis and also due to the downwards revision of the surplus of social security by 0.1% in 2002 and 0.2% in 2003 The debt figures for the years 2002 and 2003 were slightly revised downwards from 109.9 to 109.3% of GDP in 2003 and from 112.5 to 112.2% of GDP in 2002. The main reason of this revision was due to the reclassification of a mutual fund in the social security sector.

Eurostat did not validate the figures in this EDP notification. According to the press release of 18 March '*(T)his is mainly due to a newly communicated inconsistency in the recording of flows between Greece and the EU budget. In addition, data for government deficit for the years 2002 and 2003 have also been revised by the Greek authorities in their March 2005 notification. These revisions were mainly due to the fact that a new law concerning the repayment of debt of hospitals was adopted at the end of 2004 by the Greek government. This revealed that unpaid expenditure by hospitals for the past years had not been properly booked when expenditure was incurred. Moreover, data on expenditure arrears of hospitals and on government expenditure for the Olympic Games are not yet final. This could lead to a further upward revision in the deficit figures.'*

Annex 2: Summary tables from the stability programme March 2005 revised update

Table A : Basic assumptions (baseline scenario)

	2004	2005	2006	2007
Euro area short-term interest rate (annual average)	**2.1**	**2.6**	**3.5**	**3.6**
Euro area long-term interest rate (annual average)	**4.0**	**4.6**	**4.8**	**5.1**
USA: short-term (3-month money market)				
USA: long term (10-year government bonds)				
US$/€exchange rate (annual average)	**1.24**	**1.32**	**1.32**	**1.32**
Nominal effective exchange rate (euro area)				
Nominal effective exchange rate (EU)				
World GDP growth rate				
Industrialised countries GDP growth rate	3.6	2.9	3.1	2.9
World excluding EU, GDP growth				
USA GDP growth				
Japan GDP growth				
EU - GDP growth	**2.4**	**2.0**	**2.4**	**2.4**
Growth of relevant foreign markets				
World import volumes, excluding EU	**12.8**	**8.6**	**7.7**	**7.7**
World import prices, (goods, in euro)				
Oil prices (Brent USD/barrel)	**37.8**	**44.8**	**41.4**	**35.0**
Non-oil commodities prices (in USD)				

Table A 1. Growth and associated factors (reference scenario)

	2003	2004	2005	2006	2007
GDP growth at constant market prices (7+8+9)	**4.7**	**4.2**	**2.9**	**3.0**	**3.0**
GDP *level* at current market prices (€bn.)	**153.4**	**165.3**	**175.9**	**186.7**	**198.0**
GDP deflator	**3.5**	**3.4**	**3.4**	**3.1**	**2.9**
HICP change					
Employment growth	**1.3**	**2.8**	**0.9**	**1.0**	**1.0**
Unemployment rate	10.4	11.0	11.0	10.8	10.4
Labour productivity growth	3.3	1.3	2.0	2.0	2.0
Sources of growth: percentage changes at constant prices					
1. Household consumption expenditure	**4.0**	**3.3**	**3.0**	**3.0**	**3.0**
2. Government and NPISHs consumption expenditure	**-2.3**	**6.5**	**1.5**	**-1.5**	**-1.3**
3. Gross fixed capital formation	**13.7**	**4.9**	**2.9**	**2.4**	**2.9**
4. Changes in inventories and net acquisition of valuables	**0.1**	**0.2**	**0.0**	**0.0**	**0.0**
5. Exports of goods and services	**1.0**	**10.0**	**6.0**	**7.3**	**7.0**
6. Imports of goods and services	**4.8**	**8.2**	**3.7**	**3.9**	**3.8**
Contribution to GDP growth					
7. Final domestic demand	**5.8**	**4.6**	**3.0**	**2.5**	**2.6**
8. Change in inventories and net acquisition of valuables	**0.1**	**0.1**	**-0.2**	**0.0**	**-0.1**
9. External balance of G&S	**-1.3**	**-0.5**	**0.1**	**0.4**	**0.4**

Table A 2. General government budgetary developments (reference scenario)

in % of GDP	**2003**	**2004**	**2005**	**2006**	**2007**
Net lending by sub-sectors					
General government	**-5.2**	**-6.1**	**-3.7**	**-2.9**	**-2.4**
Future measures					
Central government*	**-8.1**	**-9.3**			
State government					
Local government*	**0.1**	**0.1**			
Social security funds*	**2.8**	**3.0**			
General government					
Total receipts	**43.4**	**44.4**	**45.4**	**46.1**	**46.7**
Total expenditure	**48.6**	**50.4**	**49.1**	**49.0**	**49.2**
Future measures					
Budget balance	**-5.2**	**-6.1**	**-3.7**	**-2.9**	**-2.4**
Interest expenditure	**5.8**	**5.8**	**5.4**	**5.6**	**5.7**
Primary balance	**0.6**	**-0.4**	**1.8**	**2.7**	**3.3**
Components of revenues					
Taxes	23.5	23.2	23.7	23.9	24.0
Social contributions	15.5	16.3	16.9	17.6	18.2
Interest income					
Other	4.4	4.9	4.8	4.6	4.5
Total receipts	43.4	44.4	45.4	46.1	46.7
Components of expenditure					
Collective consumption	10.2	10.9	10.7	10.3	9.9
Social transfers in kind					
Social transfers other than in kind	17.8	18.7	19.6	20.5	21.6
Interest expenditure	5.8	5.8	5.4	5.6	5.7
Subsidies	0.2	0.1	0.1	0.1	0.1
Gross fixed capital formation	4.0	4.1	3.3	3.1	2.9
Other	10.6	10.8	10.0	9.4	9.0
Total expenditure	48.6	50.4	49.1	49.0	49.2

* Data from 2005 onwards are provided for base scenario only

Table A 3. General government debt developments (reference scenario)

in % of GDP	2003	2004	2005	2006	2007
Gross debt level	**109.3**	**110.5**	**109.5**	**107.2**	**104.7**
Change in gross debt	**-2.9**	**1.2**	**-1.0**	**-2.3**	**-2.5**
Contributions to change in gross debt					
Primary balance	**-0.6**	**0.4**	**-1.7**	**-2.7**	**-3.3**
Interest expenditure	**5.8**	**5.6**	**5.4**	**5.6**	**5.7**
Nominal GDP growth	**4.7**	**4.2**	**2.9**	**3.0**	**3.0**
Other factors influencing the debt ratio	0.6	3.0	1.9	1.2	1.2
of which: Privatisation receipts		*-0.5*	*-0.6*	*-0.3*	*-0.1*
p.m. implicit interest rate on debt					

Table A 4. Cyclical developments (reference scenario)

in % of GDP	2003	2004	2005	2006	2007
GDP growth at constant prices	**4.7**	**4.2**	**2.9**	**3.0**	**3.0**
Actual balance	**-5.2**	**-6.1**	**-3.7**	**-2.9**	**-2.4**
Interest payments	**5.8**	**5.8**	**5.4**	**5.6**	**5.7**
Potential GDP growth		3.3	3.4	3.2	3.0
Output gap		2.1	1.6	1.5	1.5
Cyclical budgetary component					
Cyclically-adjusted balance		-7.0	-4.4	-3.5	-3.0
Cyclically-adjusted primary balance		-1.3	1.0	2.1	2.6

Table A 5. Divergence from previous update (reference scenario)

in % of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	**4.0**	**4.2**	**4.0**	**3.8**	**na**
Latest update	**4.7**	**4.2**	**2.9**	**3.0**	**3.0**
Difference	**0.7**	**0**	**-1.1**	**-0.8**	
Actual budget balance					
Previous update	**-1.4**	**-1.2**	**-0.5**	**0.0**	**na**
Latest update	**-5.2**	**-6.0**	**-3.7**	**-2.9**	**-2.4**
Difference	**3.8**	**4.8**	**3.2**	**2.9**	
Gross debt levels					
Previous update	**101.7**	**98.5**	**94.6**	**90.5**	**na**
Latest update	**109.3**	**110.5**	**109.5**	**107.2**	**104.7**
Difference	**7.6**	**12.0**	**14.9**	**17.3**	

Table A 6. Long-term sustainability of public finances

in % of GDP	2000	2005	2010	2020	2030	2040	2050
Old age pensions	12.9	12.4	12.2		17.3		22.6
Health care (including care for elderly)							
Health care – alternative hypothesis (including care for elderly)							
Education							
Unemployment benefits							
Total							
Assumptions							
Labour productivity growth	4.4	2.5	2.5		1.75		1.75
Real GDP growth	4.2	3.7	3.7		0.73		0.85
Participation rates males (aged 15-64)							
Participation rates females (aged 15-64)							
Total participation rates (aged 15-64)							
Unemployment rate	11.1	7.1	7.0		6.7		5.5

Annex 3 : Indicators of long term sustainability

Main assumptions - baseline scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Total age-related spending	21.0	20.8	23.6	26.5	29.6	32.6	11.7
Pensions	12.3	12.2	14.8	17.3	20.0	22.6	10.3
Health care	5.1	5.2	5.6	5.9	6.3	6.6	1.5
Education**	3.2	3.0	3.0	3.0	3.1	3.2	0.0
Unemployment benefits**	0.4	0.4	0.3	0.3	0.3	0.2	-0.1
*Total primary non age-related spending**	22.4						
*Total revenues**	46.2						

* constant

** EPC projections

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Reference scenario							
Gross debt	101.9	95.5	86.7	119.8	204.0	347.0	245.2
i + 0.5*	102.4	96.9	92.8	132.8	230.1	397.0	294.6
2004 scenario							
Gross debt	110.1	111.3	143.0	229.7	389.1	629.2	519.1
i + 0.5*	110.6	112.9	150.9	249.2	432.0	714.4	603.8

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.

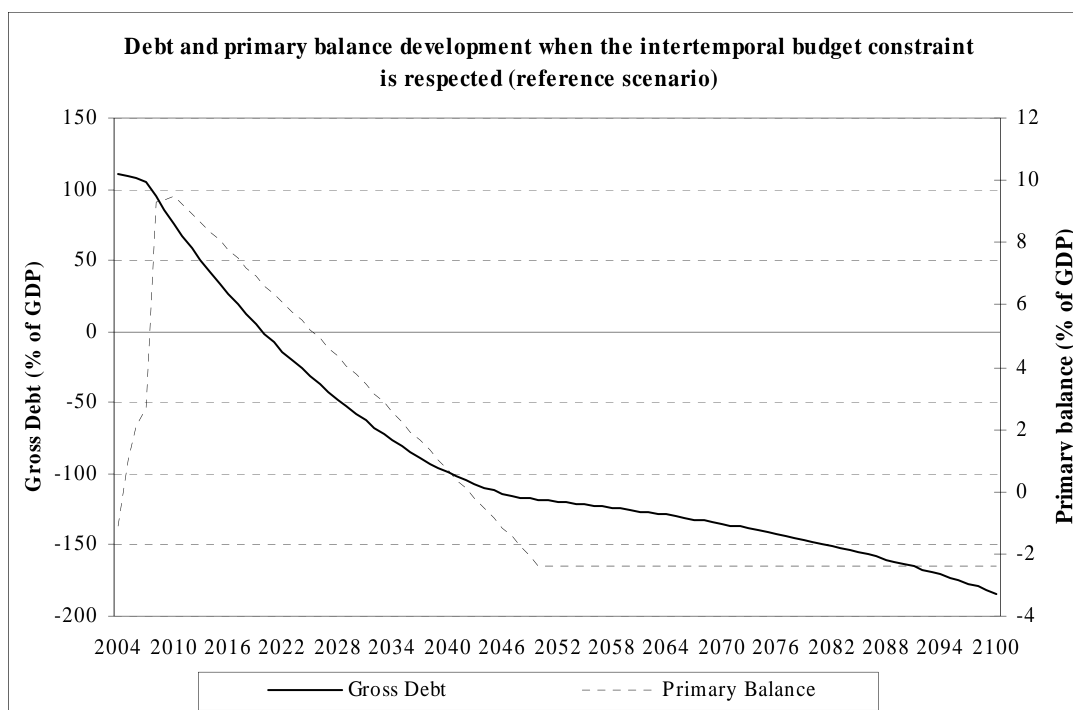

Figure 1

Main assumptions - baseline scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Total age-related spending	21.0	20.8	23.6	26.5	29.6	32.6	11.7
Pensions	12.3	12.2	14.8	17.3	20.0	22.6	10.3
Health care	5.1	5.2	5.6	5.9	6.3	6.6	1.5
Education**	3.2	3.0	3.0	3.0	3.1	3.2	0.0
Unemployment benefits**	0.4	0.4	0.3	0.3	0.3	0.2	-0.1
*Total primary non age-related spending**	20.2						
*Total revenues**	43.1						

* constant

** EPC projections

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Baseline scenario							
Gross debt	99.8	94.7	94.8	139.5	239.6	403.3	303.5
i + 0.5*	100.3	96.1	101.0	153.3	268.3	459.2	358.9
2004 scenario							
Gross debt	106.1	105.2	127.7	202.4	344.7	562.8	456.7
i + 0.5*	106.6	106.7	135.0	220.1	383.2	639.0	532.4

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.