COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

# COUNCIL OPINION

**in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997**

**On the updated stability programme of Greece, 2006-2009**

(presented by the Commission)

# EXPLANATORY MEMORANDUM

## 1. General background

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first stability programme of Greece was submitted in June 2000. In accordance with the Regulation, the Council delivered an opinion on it on 12 February 2001 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

## 2. Background for the assessment of the updated programme

The Commission has examined the most recent update of the stability programme of Greece, submitted on 18 December 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the country's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure)

(3) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme); and

(4) the Commission's assessment of the October 2006 national reform programme.

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[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

## 2.1. Recent economic and budgetary performance

Greece has experienced high economic growth and is closing the gap with the EU-25 in terms of living standards[2]. It faces high inflation originating from a mixture of high potential growth and structural problems (product market rigidities). Despite labour shortages in specific sectors, labour market rigidities hinder the reallocation of labour and thus, unemployment remains high, which points to possible mismatches between skills and firm's needs, while participation is low by EU standards, especially of women. Although labour productivity growth is healthy, unit labour costs are increasing faster and in excess of Greece's main trade partners in the euro-area, thus worsening the competitive position of the country. Consequently, Greece records high trade deficits, only partly compensated by surpluses in services. Behind the external deficit largely lies the deficit of the public sector. Greece has traditionally recorded deficits above 3% of GDP. Greece is a high debt country that also faces the risks of the growing cost of the public health system and other current expenditures. This public expenditure pattern is worrying not only because external borrowing is not channelled to productive investments, but also because the external borrowing is dependent on the credibility and sustainability of public finances.

## 2.2. The excessive deficit procedure for Greece

On 5 July 2004 the Council adopted a decision stating that Greece had an excessive deficit in accordance with Article 104(6). At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2006.

On 18 January 2005, the Council decided in accordance to Article 104(8) that Greece had not taken effective action in response to this recommendation and, in accordance with Article 104(9), on 17 February 2005, the Council decided to give notice to Greece to take measures for the deficit reduction judged necessary to remedy the situation. According to this notice, the excessive deficit still has to be corrected by 2006. On 6 April 2005, the Commission adopted a communication to the Council on the action taken by the Greek authorities in response to the Council notice, taking account of the March 2005 update of the stability programme submitted as part of the follow-up to the Council notice. The communication concluded that, on then available information, the Greek government had taken decisions consistent with the Council notice so that no further steps under the EDP were needed at that stage. In its meeting of 12 April 2005, the Council concurred with this assessment.

## 2.3. The assessment in the Council opinion on the previous programme

On 14 March 2006, the Council adopted its opinion on the previous update of the stability programme, covering the period 2005-2008. The Council “welcome[d] the efforts undertaken so far and the priority given by the government to a permanent reduction of the deficit”. The Council noted that “overall, the programme is consistent with the correction of the excessive deficit by 2006, subject to a full implementation of the envisaged adjustment and conditional

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[2] On 22 September, the Greek authorities transmitted to Eurostat new GDP data for the period 1995–2005, showing a sharp revision of GDP levels. This revision was carried out within the regular assessment process of compliance with Eurostat's statistical practices. However, the update of the stability programme (and the 2007 Budget Law) does not take into consideration the revised GDP figures. Given the magnitude and complexity of the revision, which is still undergoing complete verification by Eurostat, the Commission in its assessment of the updated programme has used the series of GDP data preceding such revision.

on the effects on the planned deficits of possible further statistical revisions of budgetary data". In the light of the recommendations made by the Council under Article 104(9) of 17 February 2005, the Council invited Greece to:

"(i) implement the necessary permanent measures leading to the correction of the excessive deficit by 2006 at the latest;

(ii) further pursue the reduction of the deficit in structural terms towards the MTO set in the programme, taking advantage of good economic times to reduce primary spending;

(iii) enhance the efforts to identify and control factors other than net borrowing that contribute to the change in the debt levels, in order to ensure that the debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace;

(iv) control public pension expenditure, resolutely implement the approved pension reforms and carry out additional structural reform to ensure the long term sustainability of the public finances;

(v) further improve the collection and processing of the general government data, notably by enhancing the mechanisms that ensure a prompt and correct supply of budgetary data, in particular on social security".

### 2.4. The Commission assessment of the October 2006 national reform programme

The implementation report of the national reform programme of Greece, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on October 2006. Greece's national reform programme identifies as key challenges: fiscal consolidation; R&D and innovation; modernising public administration; active labour market policies and the reforms of education and training.

The Commission's assessment of this programme (adopted as part of its December 2006 Annual Progress Report[3]) showed that Greece is making limited progress in the implementation of its national reform programme. Greece is moving ahead relatively strongly in the macro-economic area, whereas progress with micro-economic and employment reforms is still insufficient. Regarding governance, better coordination and stronger ownership among administrative levels is needed.

Against the background of strengths and weaknesses identified, Greece was recommended to take action in the areas of: fiscal consolidation; public administration; employment protection; education.

3 Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery" - COM(2006) 816, 12.12.2006.

**Box: Main points covered by the assessment**

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[4];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[5], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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4 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

5 "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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**in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997**

**On the updated stability programme of Greece, 2006-2009**

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[6], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [27 February 2007] the Council examined the updated stability programme of Greece, which covers the period 2006 to 2009[7].

(2) The macroeconomic scenario underlying the programme envisages that real GDP growth will be broadly stable at around 4% per year. Assessed against currently available information, this scenario appears to be based on plausible growth assumption for 2006 and 2007 but on favourable ones thereafter when the projected evolution of growth appears to be on the high side. The programme's projections for inflation appear to be on the low side in the outer years of the programme period.

(3) For 2006, the general government deficit is estimated at 2.6% of GDP in the Commission services' autumn 2006 forecast and in the new update, fully in line with the target set in the previous update of the stability programme. Total expenditures achieved the target set in the 2006 budget. While the main categories of expenditure broadly achieved the targets, a reduction in social transfers other than in kind fully compensated a ½% of GDP overrun in public investment. Total revenues were marginally higher than expected. One-off measures were partly substituted by

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6 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

7 The update was submitted 2 weeks beyond the 1 December deadline set in the code of conduct.

permanent measures implemented in the middle of the year, namely increases of the excise tax on fuel and cigarettes, and a tax increase on mobile connection bills. Revenues from these permanent measures compensated for the reduction in one-off revenues from 0.6% of GDP set in the 2006 budget to 0.4% of GDP.

(4) The budgetary strategy in the programme aims at correcting the excessive deficit in 2006. Thereafter, the government deficit is planned to continue narrowing steadily over the programme period, to 1.2% of GDP in 2009. The deficit reduction by 1½ percentage point of GDP between 2006 and 2009 is spread almost equally between revenue increase and expenditure reduction. On the revenue side, total revenue is expected to increase by ¾ p.p. of GDP, mainly driven by indirect taxes and social contributions. On the expenditure side, total expenditure is projected to fall by around ¾ p.p. of GDP over the same period, of which ½ p.p., corresponds to lower interest payments. As a result, reductions in primary expenditure are projected to be limited to just ¼ p.p.. Social transfers are projected to increase by ½ p.p., which would be more than compensated by reductions amounting ¾ p.p. in other expenditure categories, mainly collective consumption. The primary surplus would improve by around 1 percentage point over the programme period, to close to 3% of GDP by 2009. Although, compared with the previous programme, the targets for 2006-2008 are broadly unchanged with the same macroeconomic scenario, the current adjustment in 2006 is more significant since the deficit outcome for 2005 (5.2% of GDP) is higher than projected in the update of December 2005 (4.3% of GDP).

(5) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve from a deficit of around 3½% of GDP in 2006 to 1¾% at the end of the programme period (2009). As in the previous update of the stability programme, the medium-term objective (MTO) for the budgetary position presented in the programme is balanced or in surplus in structural terms, which the programme does not aim to achieve within the programme period. As the MTO is more demanding than the minimum benchmark (estimated at a structural deficit of around 1½% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO lies within the range indicated for euro-area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(6) The risks to the budgetary projections in the programme appear broadly balanced until 2007 but the budgetary outcomes could be worse than projected in the programme thereafter. In particular, for 2008 and 2009, the programme does not provide sufficient information on measures envisaged and is based on a favourable macroeconomic scenario. Based on past experience, and although no slippages have been recorded for the last two years, risks of expenditure overruns over the programme period can not be excluded, while revenue shortfalls may materialise if the announced measures to fight tax evasion would turn out ineffective.

(7) In view of this risk assessment, the budgetary stance in the programme is consistent with a correction of the excessive deficit by 2006 as recommended by the Council. However, it does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations within the programme's horizon. In the years following the correction of the excessive deficit, Greece is expected to continue to experience good times. In view of this assessment,

the pace of the adjustment towards the MTO implied by the programme should be strengthened, especially after 2007, to be in line with the Stability and Growth Pact, which specifies that, for euro-area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times.

(8) Government gross debt is estimated to have reached 104% of GDP in 2006, far above the 60% of GDP Treaty reference value. The programme projects the debt ratio to gradually decline by almost 13 percentage points of GDP over the programme period, while stock-flow adjustments are very small starting from 2007. The evolution of the debt ratio after 2007 is likely to be less favourable than projected in the programme given the favourable growth projections and the risks to the deficit targets mentioned above. Nevertheless, in view of this risk assessment, the debt ratio seems to be sufficiently diminishing towards the reference value over the programme period.

(9) The long-term budgetary impact of ageing in Greece is uncertain as long-term projections of pension expenditure are not available; however, it is very likely to be well above the EU average; according to the latest available information from the 2002 updated Greek stability programme, a significant increase in pension expenditure as a share of GDP is projected over the long term. The initial budgetary position, albeit improved compared with 2005, constitutes a significant risk to sustainable public finances even before considering the long-term budgetary impact of an ageing population. Moreover, the current level of gross debt is well above the Treaty reference value and reducing it requires achieving high primary surpluses for a long period of time. Consolidating the public finances as planned, together with urgent reform measures aimed at containing the likely significant increase in age-related expenditures, would contribute to reducing risks to the long-term sustainability of public finances. Overall, Greece appears to be at high risk with regard to the sustainability of public finances. The availability of long-term projections of pension expenditure would improve the assessment of long term budgetary sustainability.

(10) The stability programme does not contain a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. In addition, it provides no systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme and, excluding 2007, its budgetary projections do not explicitly take into account the public finance implications of the actions outlined in the national reform programme. Nevertheless, the measures in the area of public finances envisaged in the stability programme seem consistent with those foreseen in the national reform programme. In particular, the majority of the measures and actions planned for 2007 in the implementation report of the national reform programme seem to have been included in the 2007 Budget Law, even if the lack of detailed description of the measures and their implementation raises doubts over the budgetary implications.

(11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[8].

The overall conclusion is that, following a significant fiscal consolidation and in a context of strong growth prospects, the programme is consistent with the correction of the excessive deficit by 2006 and it envisages progress towards the MTO, which however would not be attained within the programme period. The consolidation, which also relies on a significant decline in the interest burden, is subject to risks as specific measures are not fully spelled out after 2007.

In view of the above assessment, Greece is invited to:

(i) taking into account the good times, strengthen, after the excessive deficit has been corrected, the adjustment towards the MTO and ensure that the debt-to-GDP ratio is reduced accordingly;

(ii) continue improving the budgetary process by increasing its transparency, spelling out the budgetary strategy within a longer time perspective and effectively implementing mechanisms to monitor and control primary expenditure;

(iii) in view of the very high level of debt and the projected increase in age-related expenditure, improve the long-term sustainability of public finances by achieving the MTO, controlling public pension and healthcare expenditures and resolutely implementing the enacted reforms; and produce as soon as possible long-term projections for age-related expenditure.

8 In particular, data on general government expenditure by function, long-term sustainability and contributions to potential GDP growth are missing.

**Comparison of key macroeconomic and budgetary projections**

| | | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|
| Real GDP (% change) | **SP Dec 2006** | **3.7** | **4.0** | **3.9** | **4.0** | **4.1** |
| | COM Nov 2006 | 3.7 | 3.8 | 3.7 | 3.7 | n.a. |
| | *SP Dec 2005* | *3.6* | *3.8* | *3.8* | *4.0* | *n.a.* |
| HICP inflation (%) | **SP Dec 2006** | **3.5** | **3.3** | **3.3** | **2.8** | **2.6** |
| | COM Nov 2006 | 3.5 | 3.3 | 3.3 | 3.3 | n.a. |
| | *SP Dec 2005* | *3.5* | *3.2* | *3.0* | *2.7* | *n.a.* |
| Output gap (% of potential GDP) | **SP Dec 2006**[1] | **0.9** | **1.0** | **0.9** | **1.1** | **1.5** |
| | COM Nov 2006[5] | 1.5 | 1.5 | 1.5 | 1.8 | n.a. |
| | *SP Dec 2005*[1] | *1.1* | *1.1* | *1.1* | *1.5* | *n.a.* |
| General government balance (% of GDP) | **SP Dec 2006** | **-5.2** | **-2.6** | **-2.4** | **-1.8** | **-1.2** |
| | COM Nov 2006 | -5.2 | -2.6 | -2.6 | -2.4 | n.a. |
| | *SP Dec 2005* | *-4.3* | *-2.6* | *-2.3* | *-1.7* | *n.a.* |
| Primary balance (% of GDP) | **SP Dec 2006** | **-0.4** | **2.0** | **2.0** | **2.4** | **2.9** |
| | COM Nov 2006 | -0.4 | 2.0 | 1.8 | 1.7 | n.a. |
| | *SP Dec 2005* | *0.9* | *2.3* | *2.4* | *2.8* | *n.a.* |
| Cyclically-adjusted balance (% of GDP) | **SP Dec 2006**[1] | **-5.6** | **-3.0** | **-2.8** | **-2.3** | **-1.8** |
| | COM Nov 2006 | -5.9 | -3.3 | -3.3 | -3.1 | n.a. |
| | *SP Dec 2005*[1] | *-4.8* | *-3.1* | *-2.8* | *-2.4* | *n.a.* |
| Structural balance[2] (% of GDP) | **SP Dec 2006**[3] | **-5.6** | **-3.4** | **-2.8** | **-2.3** | **-1.8** |
| | COM Nov 2006[4] | -5.9 | -3.7 | -3.3 | -3.1 | n.a. |
| | *SP Dec 2005* | *-4.8* | *-3.7* | *-2.8* | *-2.4* | *n.a.* |
| Government gross debt (% of GDP) | **SP Dec 2006** | **107.5** | **104.1** | **100.1** | **95.9** | **91.3** |
| | COM Nov 2006 | 107.5 | 104.8 | 101.0 | 96.4 | n.a. |
| | *SP Dec 2005* | *107.9* | *104.8* | *101.1* | *96.8* | *n.a.* |

Notes:
[1] Commission services calculations on the basis of the information in the programme.
[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3] One-off and other temporary measures taken from the programme (0.4% of GDP in 2006).
[4] One-off and other temporary measures taken from the Commission services' autumn 2006 forecast (0.4% of GDP in 2006).
[5] Based on estimated potential growth of 3.7%, 3.8%, 3.6% and 3.5% respectively in the period 2005-2008.
Source:
*Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations.*