

# Quarterly Report for the Greek Economy

02 / 18

July 11<sup>th</sup>, 2018



ΙΔΡΥΜΑ ΟΙΚΟΝΟΜΙΚΩΝ & ΒΙΟΜΗΧΑΝΙΚΩΝ ΕΡΕΥΝΩΝ

# Report Overview





# Global environment: positive prospects, but also signs of fatigue

- **Global growth of 3.6% y/y** in 2018 Q1, similar to previous quarter, faster than in 2017 Q1. Prospect for **annual growth of 3.9%** in 2018 and 2019
  - **Stimulus** from low cost of money
  - **Downside risks** from escalation of trade protectionism
  - Several advanced economies produce beyond their **potential output**
- **Eurozone economy grew by 2.5% y/y** in 2018 Q1, faster than recent forecasts for the current year (EC: 2.1%)
  - **Positive impact** from investments and historically high liquidity
  - First signs of **“growth fatigue”** stemming from economic sentiment indicators, deceleration of exports growth
  - Growth rate deceleration below 2.0% already as of 2019



# Global environment: increasing downside risks

## Globally

- Trade protectionism: escalation by the USA and counter-measures by partners
- High public debt in advanced economies
- High private debt in emerging economies
- Pro-cyclical fiscal policy (e.g. USA): fiscal buffer for future shocks?

## Eurozone

- Euro-skepticism in member states (Italian elections, refugee flows management)  
→ Need for deepening of EMU institutions?
- Banking system: high stock of Non-Performing Loans
- Macroeconomic imbalances among member states



# Further GDP growth acceleration in 2018 Q1

2018 Q1: **+2.3% y/y**, versus +2.0% y/y in 2017 Q4 and marginal growth by 0.3% y/y in 2017 Q1

## Main changes in GDP components:

- External sector balance improvement by €1.55 bn y/y (69%)
  - Exports expansion by 7.6% y/y, faster than a year ago (+5.2%), primarily through a rise in goods' exports (+10.5% y/y)
  - Imports contraction by 2.8% y/y, inter alia due to strong base effect a year ago (+11.2% y/y), primarily due to lower imports of goods (-6.1% y/y)
- Significant drop of investments by 12.1% y/y
  - Impact from temporary factors: base effect due to last year's extraordinary rise of investments in transport equipment – related military equipment (+213% y/y)  
→ high correlation with investments in ships
  - Rise in all other components of fixed capital formation, mainly ICT, machinery
- Weakening private consumption (-0.4% y/y), at slow pace, for third consecutive quarter



# State budget execution above targets

- **Jan.-May cash balance outturn: deficit €824 mill.**, versus deficit target of €2.16 bn
- **Primary surplus of €1.52 bn**, versus target of €180 mill., but also last year's outturn of €1.84 bn
- **Targets' overperformance** stemming from:
  - Higher State budget revenues
    - Overperformance concerning EU inflows for Public Investment Program (+462 mill.) → however, as in previous year, significant under-execution (lower spending by €516 mill.)
    - Higher net revenues in the Ordinary Budget (+€372 mill.): higher receipts from property tax and indirect taxes from previous financial years
  - Expenditure containment in the State budget, exclusively through under-execution of the Public Investment Program

## • Conclusion of the fourth review – third Program

- ❖ Additional resources to serve as cash buffer
- ❖ Additional measures on debt – low gross financing needs in the medium term
- ❖ Enhanced post-program surveillance framework
- ❖ No additional fiscal measures

- Credibility enhancement
- Sovereign rating upgrade
- Easing funding conditions for public – private sectors

- Continuing pressure from new measures of direct and indirect taxation in 2018, particularly towards wage earners, pensioners, and self-employed
- Fiscal space and tax cuts

The effectiveness of new debt measures in the long-term will depend upon the reform implementation momentum, which will enhance confidence towards economic policy and the attractiveness of the Greek economy, improving the parameters that affect it (growth rate, interest rates)



# Banks steadily in transitory phase

## Stress test's positive outcome

- ❖ Relaxation of capital controls
- ❖ Credit rating upgrade
- ❖ Slow return of deposits until stress test results announcement
- ❖ Shrinking NPEs, albeit still at a high level
  - ❖ Focus on qualitative features (e.g. Sales rather than write-offs)
- ❖ Q-E towards its completion, rather small likelihood for eligibility (especially without a waiver)

## *Consequently:*

- ❖ Gradual improvement of the financial system's structural features
- ❖ A drastic change of credit policy is not feasible
- ❖ Need for a steady and significant return of deposits
- ❖ Credit contraction likely to continue, with the exception of some sectors (e.g. Tourism)





# Public sector's larger contribution to liquidity - investments

- **Possibility to accelerate clearance of public sector arrears**
  - €1.5 bn have been disbursed in 2018 Q2 for this purpose (+€750 mill. "national participation")
  - They are adequate to cover a large share of state arrears recorded in past April ( $\approx$  €3.3 bn)
- **Launch of investments in privatisations where licensing has been completed**
  - Indicative examples: Vouliagmeni Astir, regional airports, Hellenikon
  - Several actions already completed by TAIPED in 2018: sale of OTE's 5%, sale of OLTH, preferred bidder for DESFA. Also, larger number of expected actions than in any previous year, leading to a high revenue target
- **But also, under-execution of the Public Investment Program for a second consecutive year**
  - Spending during Jan.- May close to last year's low level (€794 mill. vs €755 mill.)
  - The higher absorption of EU funds offers an opportunity for acceleration soon. But the benefits of a front-loaded execution are foregone.



# Trends in economic indicators

## Industrial Production

- Flat industrial production during Jan.-Apr. 2018 (compared to +7.1% last year)

## Construction

- Flat activity in the construction sector during 2018 Q1, compared to +14.6% a year ago
- Turnover 61 ppts lower than in 2010

## Tourism sector

- Significant rise in turnover by 10.9% during 2018 Q1, versus just +0.9% last year

## Retail trade

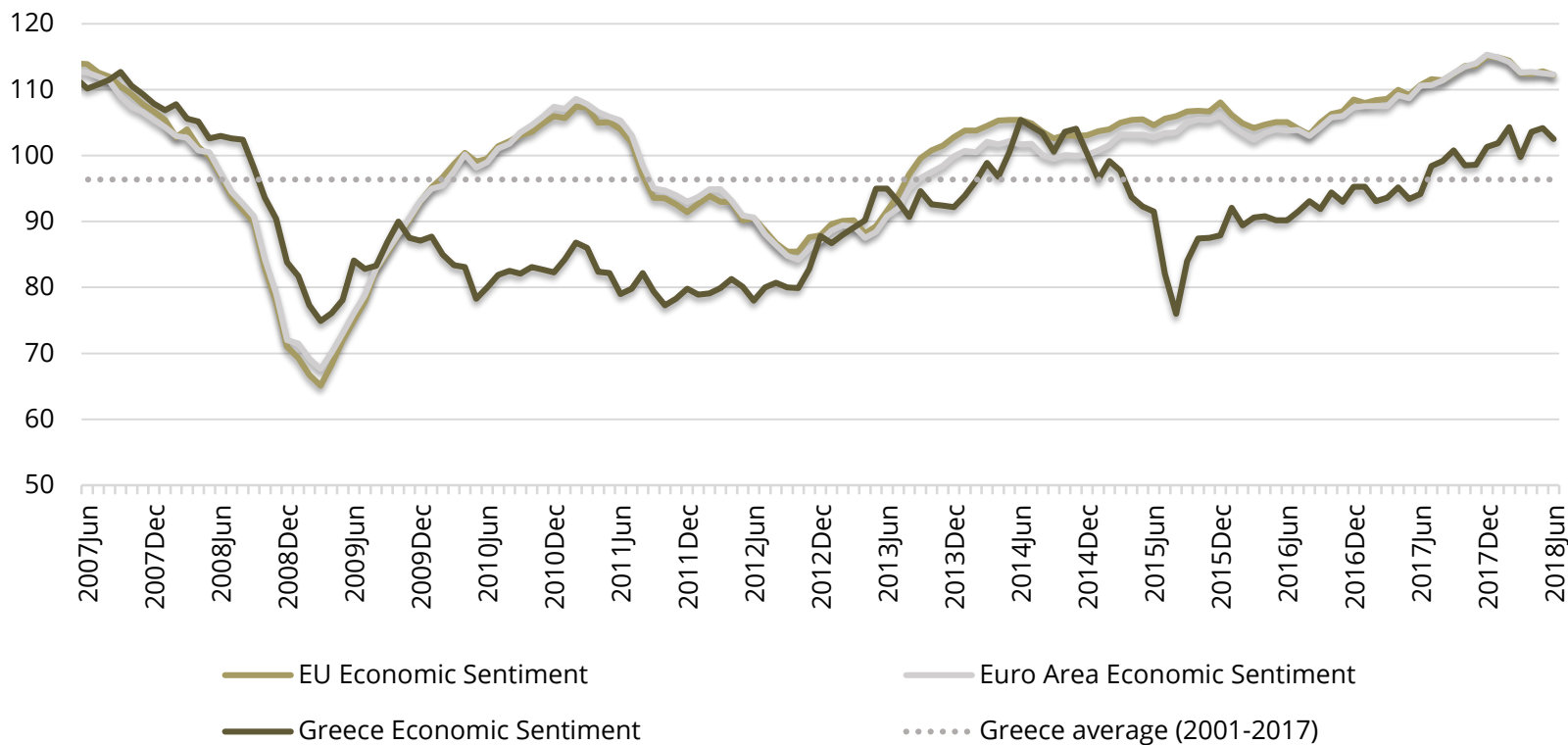
- Milder improvement in the first four months (+0.8% vs +2.6%)
- Larger increase in Furniture, Electrical and House Equipment (8.4% vs 2.1%) and Large Food Stores (3.1% vs 3.0%)
- Stronger losses in Food and Beverages (-8.0% vs -4.7%) and Books (-0.7% from +10.6%)



# Slight improvement of economic sentiment in Q2 compared to Q1: better than one year ago



## Economic Sentiment Index

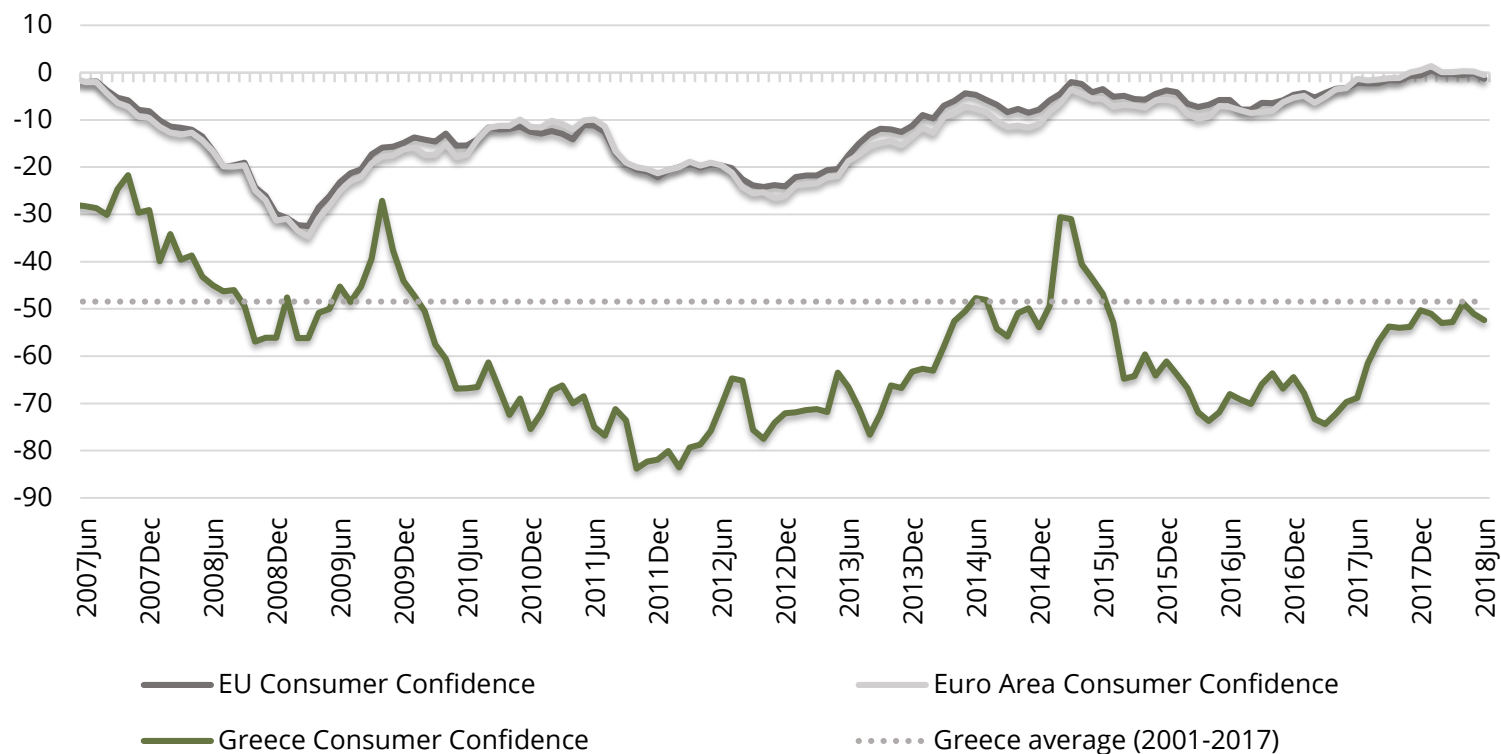


Sources: IOBE, European Commission



# Smaller improvement of consumer confidence, albeit at a higher level than last year

## Consumer Confidence



Sources: IOBE, European Commission



# Unemployment rate back to the 2012 level

## Number of unemployed persons and unemployment rate in Greece

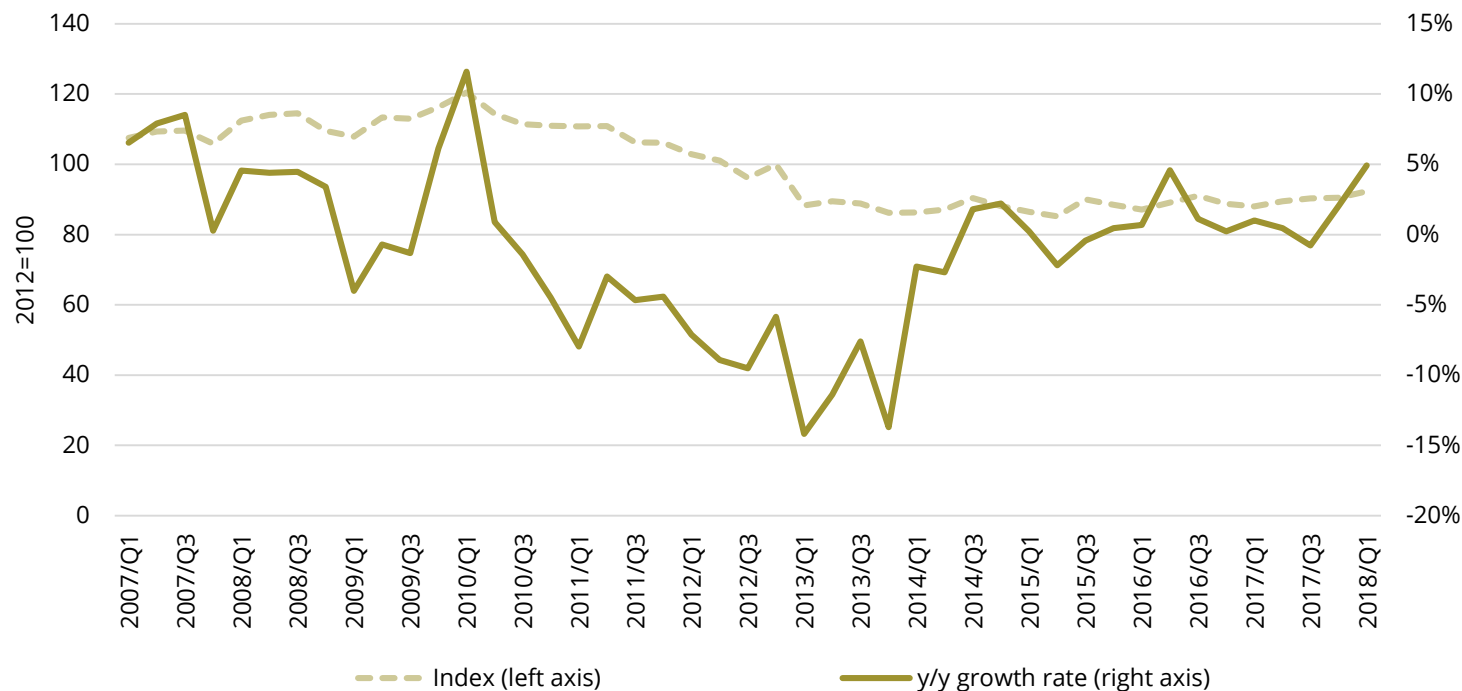


Source: ELSTAT

- 21.2% in 2018 Q1, from 23.3% in 2017 Q1 and 24.9% in 2016 Q1
- Employment increase in 13 sectors. Indicatively: Health and social welfare activities (+24.0 thous.), Agriculture-Forestry-Fishing (+14.7 thous.), Wholesale-Retail trade (+10.2 thous.), Other service activities (+9.0 thous.), Professional-Scientific-Technical activities (+8.5 thous.), Manufacturing (+2.6 thous.)
- Employment drop in 7 sectors. Indicatively: Education (-11.1 thous.), Financial and insurance activities (-4.9 thous.), Accommodation and catering (-1.6 thous.), Mining and Quarrying (-1.3 thous.).

# Further increase of s.a. wage cost index

## Evolution of the seasonally adjusted wage cost index

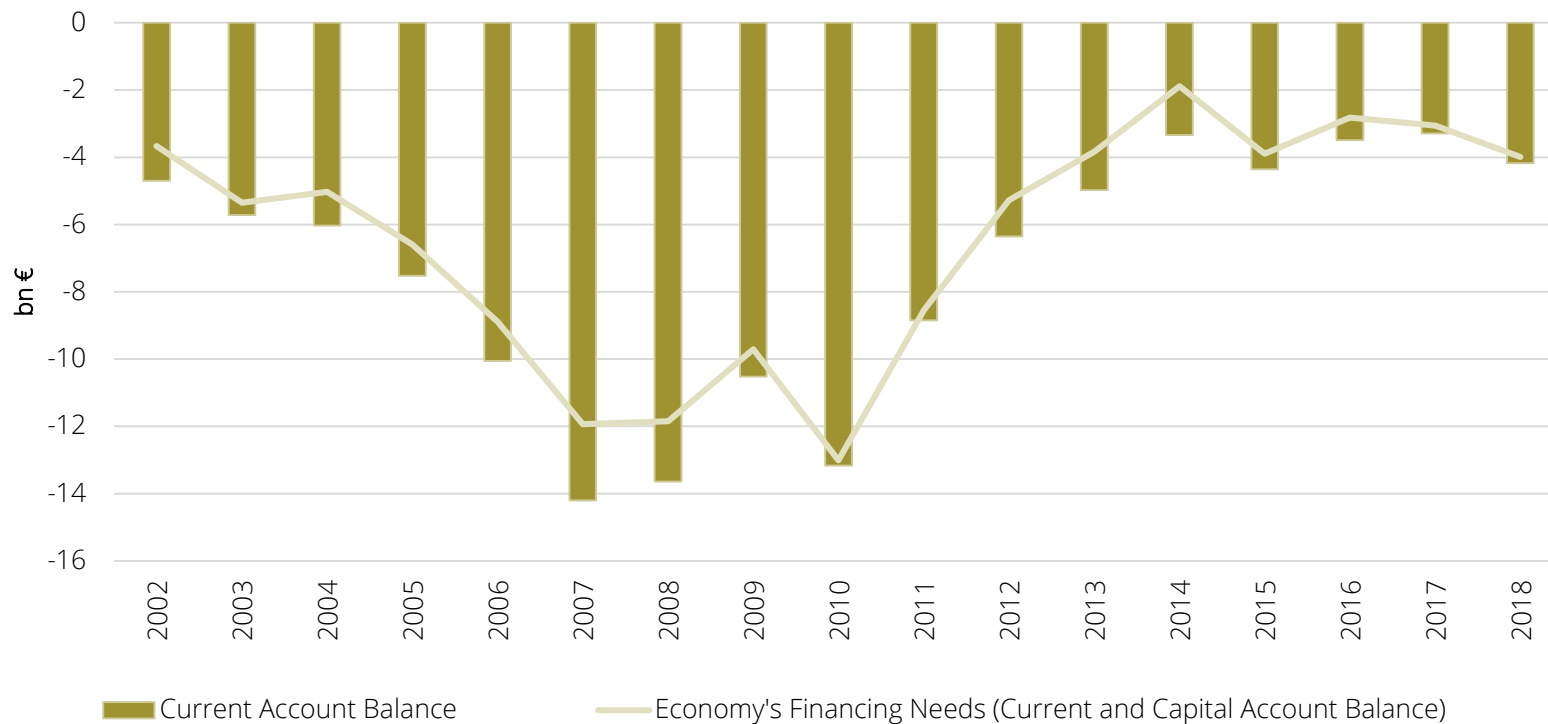


Source: Eurostat

➤ Significant rise of the index by 4.9% in 2018 Q1, following an increase of 2% in 2017 Q4



# Widening Current Account deficit in January-April

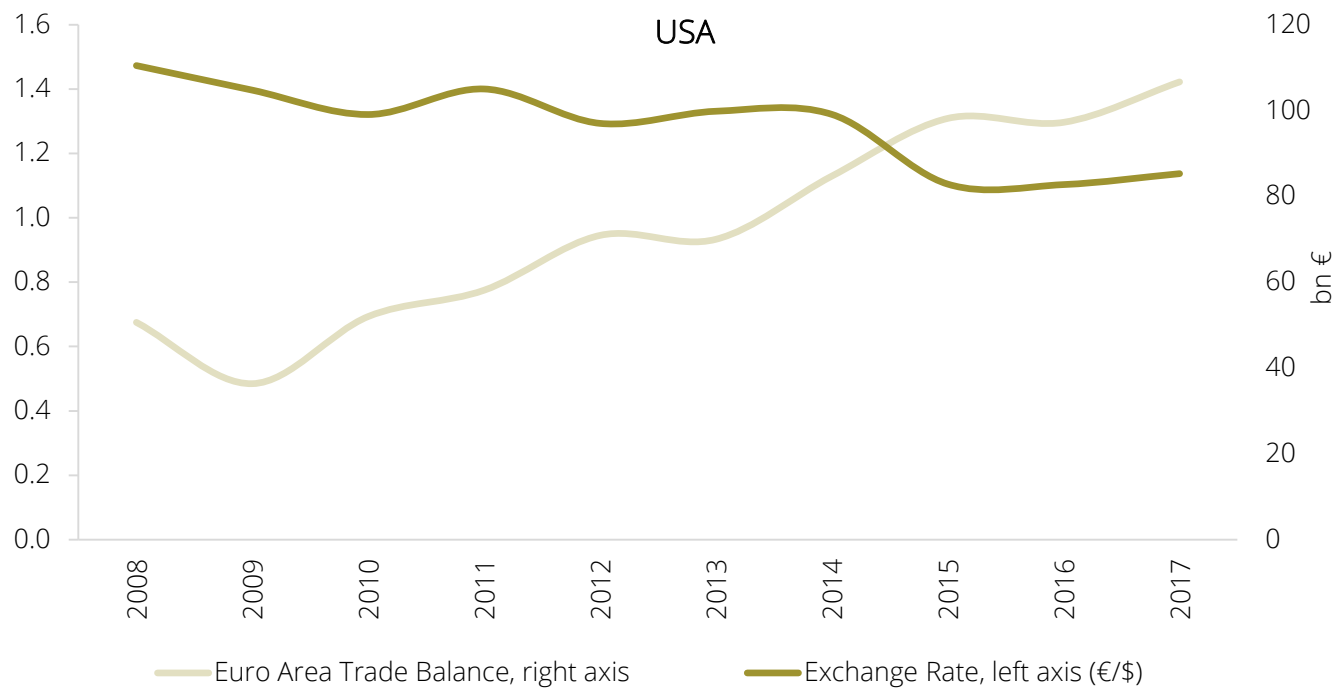


Source: BoG

- Deficit €4.2 bn, compared to €3.3 bn last year
- Important rise of goods' exports (+14%), but also rise in imports (+10%)
- Exports of goods and services: ~30% of GDP, highest level since 2002



# Significant contribution of QE to Eurozone's GDP, employment and external balance vis-à-vis the USA



Source: Eurostat

- The increase of euro money supply after 2014, has led to a devaluation of € vis-a-vis \$, which has further enhanced the Euro Area trade surplus with the USA
- During the same period, the US has been easing their respective QE program



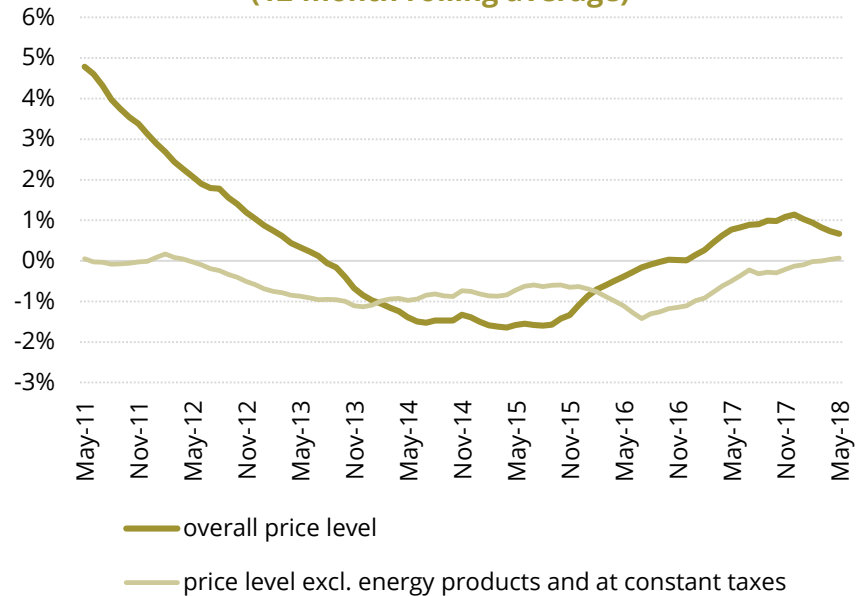


# Inflationary pressure milder than last year

### Harmonized inflation (HICP)



### Greece: Harmonized inflation (12-month rolling average)



Sources: ELSTAT, Eurostat

**Eurozone:** Inflation acceleration to 1.4% during Jan.-May 2018

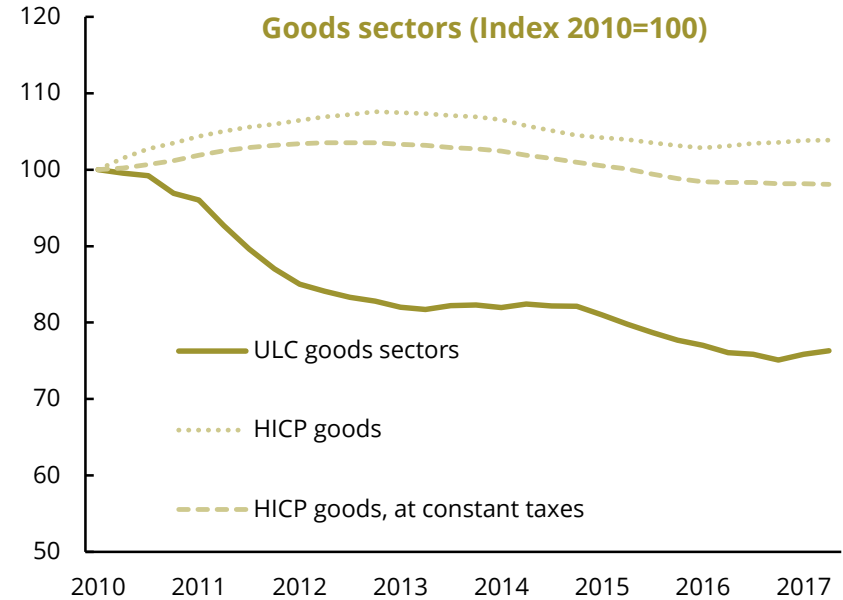
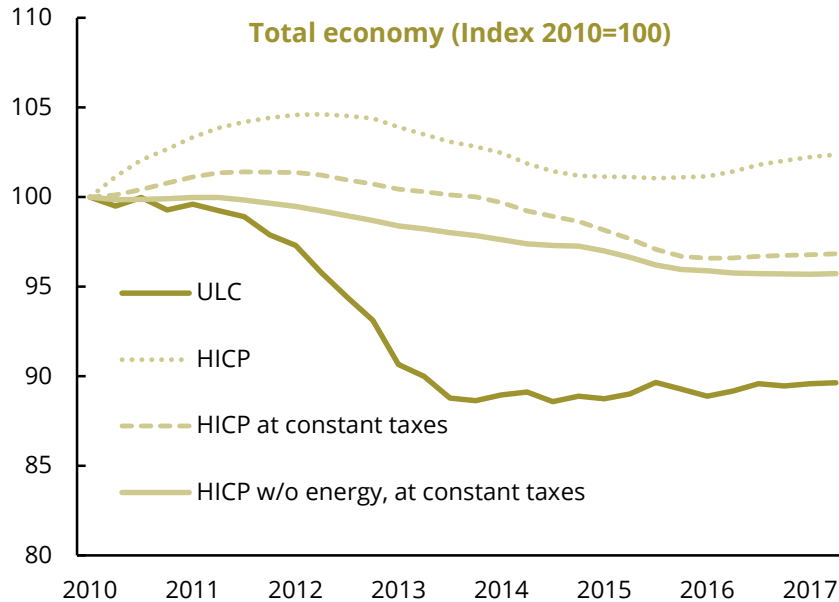
**Greece** (Jan.-May 2018, CPI based): inflation rate of 0.1%, versus +1.4% in 2017:

Milder inflationary pressure by indirect taxes and energy goods

**Producer Price Index** Jan.-May 2018: +2.2%, versus +8.1% in 2017



# Gap between the adjustment in ULC and final consumer prices



Source: Eurostat, IOBE data processing

Note. ULC in sectors of goods is calculated for sectors classified under categories A-E (NACE Rev.2)

**2010-2017:** The cumulative drop of consumer prices, at constant taxes, remains 6 pts smaller than the cumulative drop of ULC

- The deviation is more pronounced among goods sectors
- Keys: Reforms promoting competition, lower energy cost



# 2018 Forecasts

- **Mild increase of private consumption ( $\approx 0.7\%$  y/y):**

  - Further, milder drop of unemployment, driven by employment increase in extrovert sectors (Manufacturing, Transportation, Tourism), in Construction (privatisations, private building construction) and in the Public sector
  - Disposable income under pressure, due to fiscal measures, credit contraction

- **Expansion of public consumption ( $\approx 1.5\%$  y/y):**

  - The fiscal adjustment continues to rely mainly on revenue increases (abolition of tax discounts, extension of existing - imposition of new indirect taxes)

- **Stronger investment activity ( $\approx 13.0\%$  y/y):**

  - Extrovert sectors facing increasing international demand
  - Launch of investments in privatization projects
  - Large companies accessing capital markets for investment resources

Obstacles to investment activity:

  - Limited credit supply, under-execution of Public Investment Program



# 2018 Forecasts

## External sector

### **Export expansion (7.0% y/y):**

- Strong growth momentum in the EU, the USA, emerging export destinations (e.g. North Africa)
- Further booming tourism season and higher transportation activity, inter alia affected by tensions in the SE Mediterranean
- Negative impact by trade protectionist policies

### **Imports' rise, also by 7.0% y/y**

- Increase of investment activity, to the extent this concerns machinery, transport equipment, electrical appliances
- Expansionary impact from capital controls relaxation
- High exchange rate euro/dollar

**Acceleration of growth rate this year, in the area of 2.0%**



# 2018 Forecasts

## **Further drop of unemployment**

- Employment rise affected by new increase of exports' demand in Manufacturing, Tourism and Transportation
- Higher contribution from Construction sector
- Employment expansion in the public sector, both permanent and temporary

## **Average unemployment this year around 19.8%**

- Mild increase of consumption demand, low inflationary pressure by higher/new indirect taxes, contain the increase of the general price level
- Suspension of the VAT rate reduction in six islands
- Growing impact from oil prices, due to continuous global price increase during 2018 H1, partly offset by the stronger €/ \$ exchange rate y/y

## **New consumer price increase, milder than last year (around 0.5%)**



Special study\*

# **Income Taxation in Greece**

## **A comparative analysis and reform proposals**

\*Based on a study carried out on behalf of and in cooperation with the non-profit company diaNEOSis



## Study scope

- Extensive changes in the Greek tax system between 2009 and 2016
  - Tax rate increases and readjustment of other tax parameters
- In direct taxation:
  - Personal and corporate income tax rates have been adjusted
  - The majority of tax exemptions have been eliminated
  - An additional solidarity levy was applied
- The need to reform the tax system remains urgent

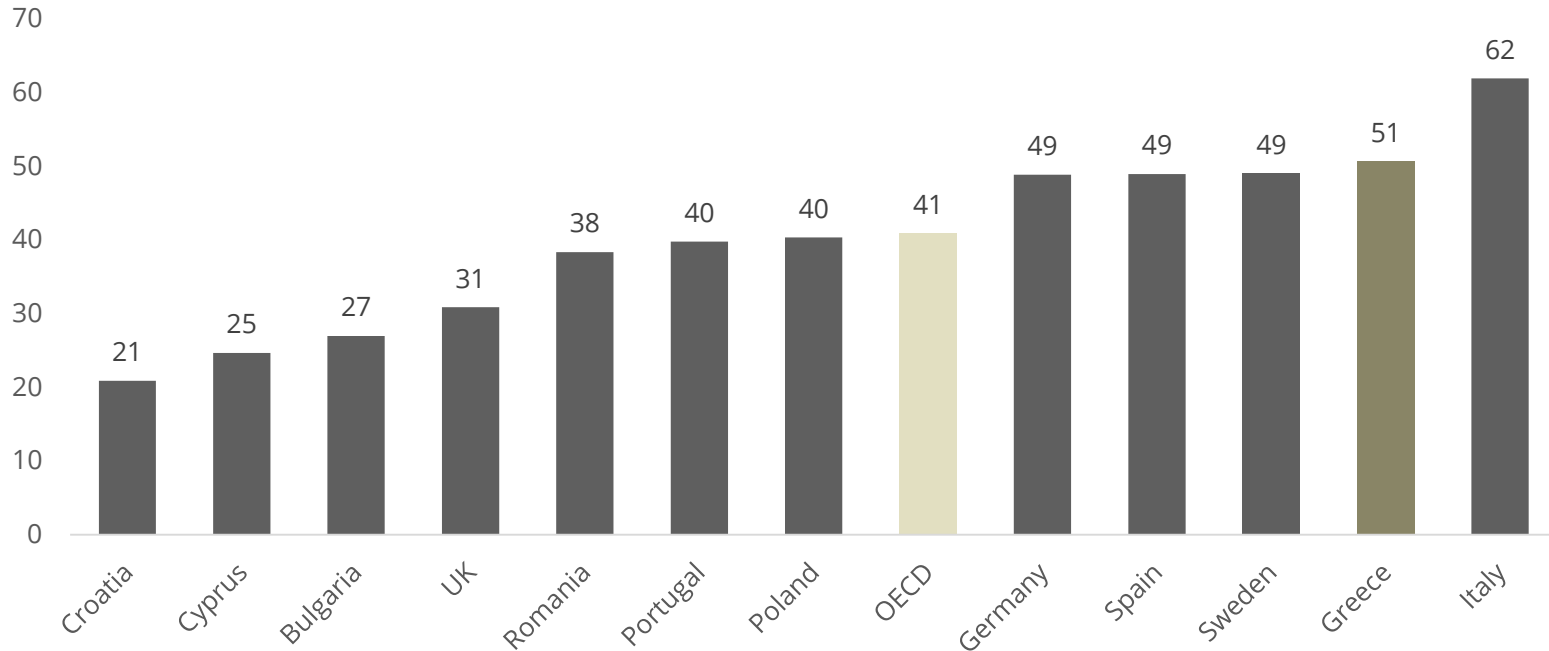
### Objectives of the study

1. Analyse the income tax system in Greece
2. Make proposals for its reform

Excessive taxation places obstacles to the country's recovery and leads to a growth slowdown of the Greek economy, with undoubtedly serious social repercussions

# The income tax system in Greece is characterised by high tax rates for both individuals and businesses

Total tax and contribution rate per country (% of profits), 2017



Source: World Bank Group, Doing Business database

As a result, incentives for work, investment and entrepreneurial activity are distorted, economic efficiency is not promoted and tax evasion and tax avoidance are encouraged





# Unsatisfactory performance across all criteria

Evaluation criteria	Income tax system performance	Rate*
<b>Economic efficiency</b>		
<ul style="list-style-type: none"> <li>Incentives and opportunities for work and business activity</li> <li>Incentives for savings and investment</li> <li>Risk taking and innovation by individuals and businesses</li> </ul>	<ul style="list-style-type: none"> <li>Relatively high (net) tax burden on personal income</li> <li>Relatively high upper tax rate on personal income</li> <li>High income tax rate for legal entities</li> <li>Low predictability of the tax system</li> </ul>	2
<b>Justice and equity</b>		
<ul style="list-style-type: none"> <li>Horizontal equity</li> <li>Vertical equity</li> <li>Income redistribution for reducing inequalities</li> </ul>	<ul style="list-style-type: none"> <li>Narrow tax base</li> <li>Excessive burden on entrepreneurs and wage earners</li> <li>High degree of progressiveness, with little effect on reducing inequalities and poverty</li> </ul>	2
<b>Simplicity and transparency</b>		
<ul style="list-style-type: none"> <li>Clear definition of the tax base</li> <li>Certainty about the tax amount for each taxable item</li> <li>Transparency</li> <li>Democratic control and information</li> </ul>	<ul style="list-style-type: none"> <li>In 2013, many exemptions and discounts were abolished</li> <li>Changes in taxation are often implemented under urgent procedures and sometimes with retroactive effect</li> <li>There are delays in the adoption of secondary legislation</li> </ul>	3
<b>Flexibility and stability</b>		
<ul style="list-style-type: none"> <li>Flexibility in the context of macroeconomic management</li> <li>Flexibility under different policy directions</li> <li>Predictability in order to facilitate the decision making process by the taxpayers</li> </ul>	<ul style="list-style-type: none"> <li>Very frequent changes in legislation</li> <li>Large number of legislative acts per law</li> <li>Large number of legislative provisions scattered in various laws</li> </ul>	1
<b>Administrative cost and compliance cost</b>		
<ul style="list-style-type: none"> <li>Minimisation of the administrative cost of the tax system (tracking, enforcement)</li> <li>Minimisation of the taxpayers' private compliance costs</li> </ul>	<ul style="list-style-type: none"> <li>Excessive employment of tax administration employees in administrative services</li> <li>The time spent on meeting tax obligations was reduced</li> <li>The number of payments for businesses also declined</li> <li>Electronic submission of tax returns</li> <li>Business compliance costs remain high compared to other European countries</li> </ul>	3

Note: \*The score ranges from 1 to 5, where 1 - Extremely unsatisfactory performance and 5 - Very good performance

Source: IOBE



# Estimation of the microeconomic impact of five reform scenarios for personal income taxation

## Evaluation of the microeconomic effects of the reform of the personal income taxation

Evaluation criteria	A: Higher progressiveness	B: Flat tax 24,3%	C: Flat tax 14,3% and abolition of tax deduction	Δ: Flat tax 20% and tax deduction up to €680	E: Two tax brackets: 20% for <€40,000 and 25% for >€40,000, tax deduction up to €690
Economic efficiency	---	++	+++	++	+
Justice and equity	+	-	---	--	-
Simplicity, transparency and stability	0	++	+++	++	+
Administrative cost and compliance cost	0	++	+++	++	+

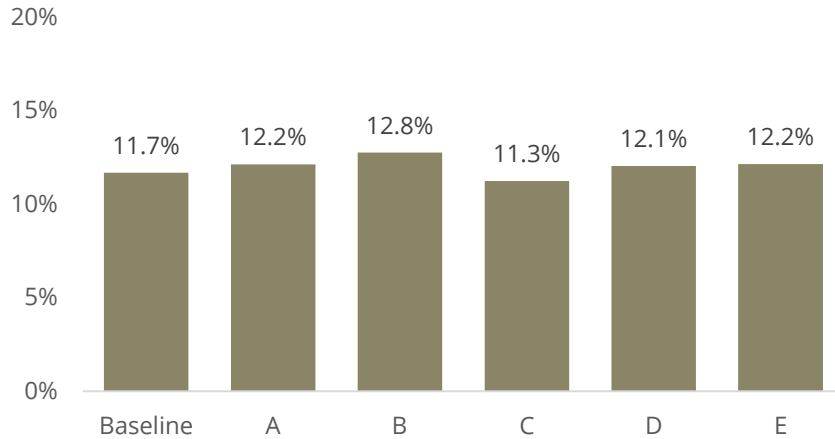
Note: ++ Strong positive effect, + positive effect, 0 no remarkable effect, - negative effect, -- strong negative effect

Source: IOBE analysis

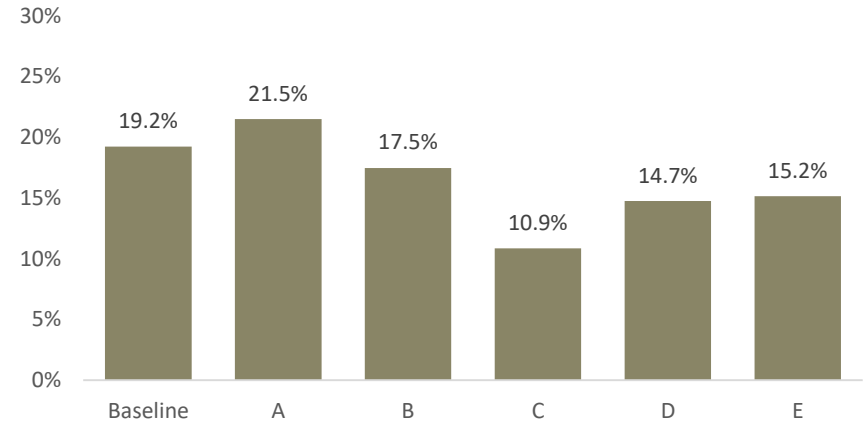


# Improving efficiency with less impact on equity is achieved with 2 tax brackets (reform scenario E)

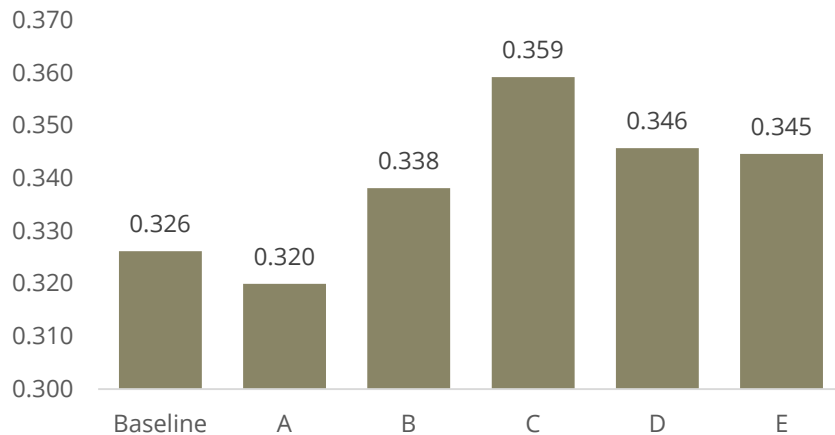
Average tax rate



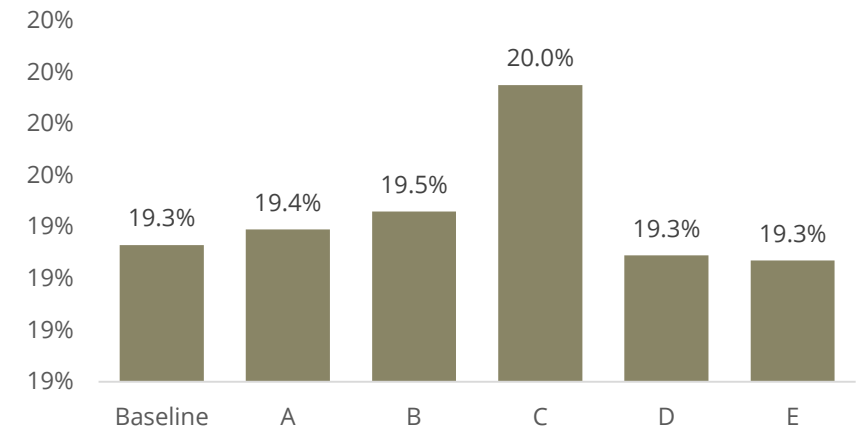
Average marginal tax rate



GINI inequality indicator



Poverty rate

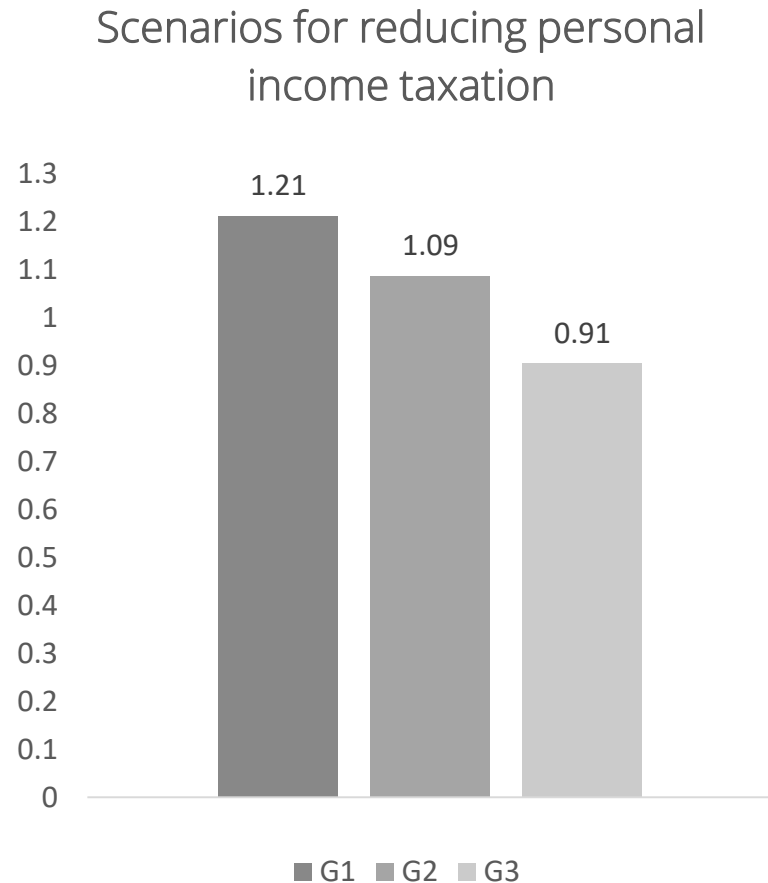
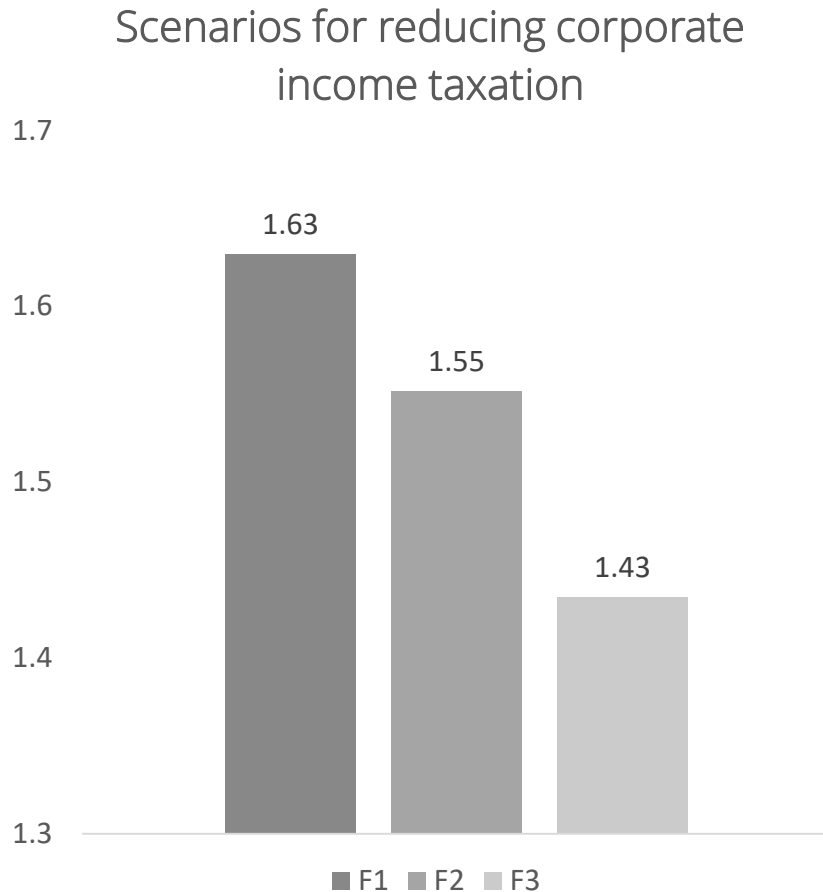


**Income equality issues are also addressed by improving the social benefits system**



# A reduction of the average corporate tax rate by 10 pps leads to an increase in GDP of 1.4-1.6. pps

Real GDP (% difference from initial steady state)



Source: IOBE analysis

Correspondingly, an increase in the GDP level by 0.9-1.2 pps in the long-term equilibrium is achieved by reducing the average personal income tax rate by 3 pps



# Policy proposals

Criterion	Measure description	Expected effect
Economic efficiency	<ul style="list-style-type: none"> <li>Decrease of personal income marginal tax rates</li> <li>No more than two personal income tax brackets</li> <li>Drastic reduction in the corporate income tax rate (maximum 20%)</li> <li>Widening of tax base by re-examining deductible business spending categories</li> <li>Decrease of social security contributions</li> <li>Possibility of offsetting business losses with future profits of more than 5 years ahead</li> <li>Deduction of capital costs from business revenues</li> </ul>	<ul style="list-style-type: none"> <li>Boosting of incentives for work, business and investments</li> <li>Limitation of tax evasion, tax avoidance and accumulation of arrears. Increase of public revenues.</li> <li>Boost of employment and growth in the economy</li> <li>Less unfavorable position of Greece in lieu of the international tax competition</li> <li>Elimination of distortions in business financing from equity or loans, as they will be equally treated</li> <li>Limited impact on the general government deficit, preventing interventions in other tax areas or public spending cuts</li> </ul>
Justice and equity	<ul style="list-style-type: none"> <li>Reduction of tax rates and number of tax brackets</li> <li>Promotion of redistribution mechanisms through public spending, rather than through tax discounts</li> <li>Gradual abolition of imputed income criteria for the determination of tax base - Use of these criteria to improve the effectiveness of tax audits</li> <li>No imposition of extraordinary or additional taxes on declared earnings</li> <li>Further use of plastic money and e-invoicing</li> <li>Intensification of tax audits and sanctions, and speeding up of tax disputes' resolution</li> </ul>	<ul style="list-style-type: none"> <li>More reasonable tax burden allocation</li> <li>Strengthening of citizens' confidence in the tax system</li> <li>Strengthening of the taxpayers' compliance</li> <li>Transparency and democratic control</li> </ul>
Simplicity, transparency and stability	<ul style="list-style-type: none"> <li>Assessment and simplification of the tax legislation</li> <li>Mandatory impact assessment in any tax bill or amendment</li> <li>Annual programming of legislative work for taxation and activity reports on a biannual basis</li> <li>Assessment of tax legislation implementation after its entry into force</li> <li>Promotion of redistribution mechanisms through public spending</li> </ul>	<ul style="list-style-type: none"> <li>Simplification of the tax legislation</li> <li>Stability of the tax framework</li> <li>Transparency and democratic control</li> </ul>
Administrative and compliance cost	<ul style="list-style-type: none"> <li>Administrative reorganisation of the tax authorities by increasing the number of employees for tax audits</li> <li>Further modernization of the tax administration and establishment of e-tax administration</li> </ul>	<ul style="list-style-type: none"> <li>Reduction of compliance costs and faster services to taxpayers</li> <li>Improvement of the effectiveness of the tax authorities</li> <li>Strengthening of the public trust in the tax system</li> </ul>

Source: IOBE analysis

# Thank you!

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