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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Economic Survey of Greece, 2007

Observer oecd

Summary

Growth performance over the last decade has been among the best in the OECD, though a precise calibration is not yet possible following the recent revisions to GDP data. High growth has been driven by a range of factors, some of which are transitory. It is particularly encouraging that growth has been sustained over the last two years, despite substantial fiscal consolidation, mainly being driven by investment and exports. However, significant further reforms are needed to ensure that good performance is sustained in the years to come. It is imperative to use this period of strong performance to tackle remaining weaknesses in product and labour markets and move fiscal policy further towards a sustainable position by vigorous continued consolidation and pension reform. The key challenge, in terms of political economy, is to manage the required reforms in a context where society may be unduly complacent because the "good times" appear to be continuing.

			Ranking among	
			12 euro area countries	30 OECD countries
Overall performance	Growth in GDP per capita	1995-2005	2nd	2nd
Employment rates	Prime age males	2005	2nd	8th
	Older workers	2005	7th	21st
	Young workers	2005	11th	27th
	Women	2005	11th	27th
Human capital	Average years of education, population 25-64	2004	9th	24th
	Tertiary graduates, share of population aged 20-29	2004	11th (out of 11)	27th (out of 29)
	Flexibility of tertiary education system	2004	11th (out of 11)	28th (out of 28)
Product market	Competition-friendly product market regulation	2003	11th	25th
	Competition-friendly regulation of network industries	2003	11th (out of 11)	21st (out of 21)
	Inward foreign direct investment (% of GDP)	2000-05	12th	29th

This Policy Brief presents the assessment and recommendations of the 2007 OECD Economic Survey of Greece. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

Fiscal consolidation has been substantial and should continue. Government debt and estimates of the prospective increase in fiscal costs from ageing are among the highest in the OECD. There is considerable scope for fiscal savings from reducing the high cost of public administration, raising efficiency in state-owned enterprises and further efforts to tackle tax evasion. But ensuring long-run fiscal sustainability will also require a fundamental overhaul of the pension system. There are substantial benefits from taking action early: debt service costs would be lowered; the tax burden would be much less skewed towards later generations; there will be more time for people to adapt; and fiscal policy would have scope to play a counter-cyclical role.

Labour market flexibility needs to be raised. While overall labour utilisation is quite high, overly rigid labour market institutions contribute to a low employment rate among the old, young and women. In particular the retirement income system provides strong disincentives to continue working, and the setting of minimum wages and strict employment protection legislation makes it difficult for first time entrants (mainly the young) and re-entrants (mainly women) to join the job market.

Human capital needs to be increased through improvements to the education system. A particular priority is reform of tertiary education where Greece currently has one of the most centralised and least flexible systems in the OECD. The recent reform is a clear and essential move in the right direction.

Product market regulation which hinders competition needs to be further improved. It has inhibited inward foreign investment in the past and has contributed towards a poor innovation performance. A particular priority is to further raise competition in network industries. ■

What are the main risks and policy challenges?

Over the past decade, Greece has progressed rapidly in closing the income gap with the best performing economies, particularly once the recent 26% upward revision to the level of GDP is taken into account. This data revision is largely the result of improved measurement of the fast-growing services sector, while, contrary to many press headlines, the contribution from the inclusion of illegal activities was less than 1% of GDP. A full assessment of growth performance is difficult because data revisions prior to 2000 have yet to be published, but it is likely that growth in GDP per capita over the past decade has exceeded 4½ per cent per annum, which would rank Greece second highest (after Ireland) in the OECD. Explanations for the rapid catch-up in living standards include: financial market liberalisation coupled with membership in monetary union, which led to a substantial reduction in borrowing costs; buoyant activity in export markets in south-eastern Europe; and the fiscal stimulus and focal point given by the Olympic games in 2004. The fact that strong growth has continued since 2004 in the context of substantial fiscal consolidation is consistent with enhanced robustness stemming from structural reforms. The strong performance over the last decade has occurred despite product and labour market regulations which are still strict in international comparison. However, product market regulations have been eased and there has been a large boost to productivity growth given an initially weak starting position. In addition, a large informal sector exists and tight regulation may be less of an impediment to growth if it is not strictly enforced. An example is the employment of illegal immigrants which has satisfied a latent demand for less-skilled workers that labour market rigidities helped to create. However, competition-impeding regulations that are weakly enforced and a large informal sector are clearly second best to a well-performing regulatory framework with people working in regular jobs, particularly because the former combination gives rise to tax evasion on a large scale.

Contrary to expectations of a post-Olympics slump, the economy has continued to grow briskly in 2005 and 2006 during a period of substantial fiscal consolidation. The government deficit has been substantially cut from a peak of 7¾ per cent of GDP in 2004 to an estimated 2½ per cent in 2006 (based on the unrevised GDP data, which are the basis for judging compliance with the Excessive Deficit Procedure, pending confirmation of the revised GDP data by Eurostat). This is the first time the deficit has been brought below 3% since the adoption of the euro. While strong growth of around 4% is expected to continue for some years, headwinds are likely to become stronger over time. The clearest sign of macroeconomic tension is an increase in the current account deficit to about 9½ per cent of revised GDP in 2006. In the absence of currency risk, this mainly serves to highlight concerns about a continuing loss in competitiveness, with consumer price inflation running at about 3¼ per cent at the end of 2006, having remained persistently above the euro area average for many years. Relatively high inflation implies low real interest rates, which fuel domestic demand. However, losses in competitiveness may ultimately undermine growth performance. They may continue for some time in a favourable external environment, but the longer they last, the larger and more protracted the adjustment in relative prices and wages that may be needed to restore competitiveness.

While short-run prospects remain good, sustaining robust growth over the longer term will necessitate further product market reforms – and their effective implementation – as well as the mobilisation of the large unused potential of labour inputs, especially among the old, young, and women and improvements in human capital. While there is considerable scope for action over a wide range of policies, the particular focus of the current *Survey* is on the five structural priorities identified in the OECD's recent *Going for Growth* publication:

- Removing the financial disincentives to work at older ages which are inherent in the pension system while constraining the possibilities for early retirement.
- Reducing the minimum cost of labour by introducing a sub-minimum wage for young people and lowering social security contributions for the low-paid.
- Reforming employment protection legislation. In particular, rebalancing employment protection across different occupations.
- Reducing barriers to entry and promoting competition in network industries.
- Making tertiary education more efficient and raising its standards to international levels.

Having front-loaded the reduction in the fiscal deficit, the government's main macroeconomic objective is to more gradually reduce the deficit, by about ½ per cent of GDP per annum until the budget is in balance or surplus by 2012 at the latest. As the government debt-to-GDP ratio is high and prospective pressures of population ageing on public health and pension spending are estimated to be among the largest in the OECD, fiscal consolidation should continue, possibly at a more rapid pace than planned taking advantage of strong economic growth. Currently Greece is the only euro area country which does not include quantitative long-term fiscal projections in the annual stability programme. To raise awareness of the impending problems a long-term fiscal scenario to mid-century should be published to show how fiscal policy will cope with the expected spending pressures from ageing. In this context, delaying fiscal consolidation might have longer-term costs in terms of additional debt service costs, including an increase in the risk premium paid on government debt, and higher taxes, which would also be more heavily skewed towards future generations. However, aggressive fiscal consolidation is at best a stop-gap. A preferable approach is for a far-reaching pension reform to be put in place soon. Achievement of the government's medium-term objective might be an adequate platform for ensuring future fiscal sustainability, if also accompanied by reforms which would help to contain future spending pressures on health, and especially, pensions. ■

How can fiscal policy be put on a sustainable path?

There has been substantial consolidation since 2004. Future consolidation should pursue a better control of primary current spending, and in particular increased efficiency of public administration. There is also scope for enhancing tax revenues further through fighting tax evasion and through other measures to broaden the tax base. Success in these efforts should allow more rapid debt reduction as well as providing resources for spending on alleviating poverty. As previously noted, ensuring long-run fiscal sustainability will also require structural reforms in the key area of health and, above all, a timely decision to comprehensively reform the pension system.

Spending on public administration absorbs a much higher percentage of total government outlays than in most other OECD countries, with no evidence that the services delivered are superior. This suggests that important social, political and economic goals could be achieved with significantly fewer resources. Recent improvements in the client friendliness of public services, notably the establishment of "one-stop shops" (Citizen Centres) for the provision of administrative services, and changes to lighten the burden of administrative regulations on business are welcome. Further steps towards simplifying procedures are nevertheless warranted. For example, the number of procedures and the time taken for starting a small business are still among the highest in the OECD, and further simplification would not only help to establish businesses, but would also require less resources to administer. A further important objective is to reduce over-staffing and raise productivity in the public sector to enhance the quality of services and contain wage pressures. Initiatives underway to improve performance evaluation and tighter recruitment procedures are therefore welcome and should be implemented without delay. Improving the performance of public enterprises should also remain a policy priority. The operating losses of such companies stood at around ½ per cent of GDP in 2006, with a similar share projected for 2007. In this context, the new law rationalising the operation of public enterprises is a step in the right direction. The rapid implementation of the new Management Information System that will improve the control and operation of public enterprises is of great importance. It will link the financial departments of the public enterprises, allowing the monitoring of their performance and the evaluation of outcomes compared with budget targets. A general concern that remains is that there has often been a gap between legislation passed on public sector reforms and their timely implementation. Thus, a focal point of public sector reform should be to ensure that policies are fully implemented once the legislation has been passed.

There is scope to make the tax system more lucrative and less distortionary at the same time. A number of reforms have been undertaken to improve the functioning of the tax system, with particular emphasis on its simplification. Recently, corporate tax rates have been reduced to promote business activity and investment and attract foreign direct investment (FDI). Another focus of the reforms is the reduction of tax evasion *via* an upgrading of tax auditing and the restructuring of audit services. The need to ensure that the tax system is more efficient and competitive limits the scope for raising revenue through higher corporate tax rates and/or increasing social security contributions, especially in view of an already high tax wedge. There is some scope to raise the rate of consumption taxes, although the indirect to direct tax ratio is already high. Accordingly efforts to raise revenue should focus on further reductions in tax evasion and a broadening of the tax base by phasing out remaining distortionary exemptions. This could be achieved by ending the preferential treatment of some products, professions and regions and eliminating many of the remaining exemptions in corporate taxation. Moreover, the remaining stamp duties and distortionary “third-party” taxes should be abolished.

As in other OECD countries, population ageing and non-demographic factors, such as technical progress and relative price movements, will put upward pressure on public health care spending. Improving the efficiency of health care services would help to contain future cost pressures. A high level of private spending on health care largely reflects inefficiencies in the public health care system that leads to excessive waiting lists. Long-standing problems include the inefficient operation of public hospitals and the lack of an effective primary health care system. On-going initiatives to tackle these weaknesses have focused on modernising the structure of the National Health Service, upgrading its management and rationalising health expenditure in critical areas. But the full effect of the reforms in containing spending is yet to come.

Additional measures will be needed to restrain health care expenditure and improve the quality of services. These include better pricing and costing mechanisms, which are part of the government's longer-term reform agenda, announced in 2004. A pricing scheme for the reimbursement of public hospitals for different types of in-patient services, if implemented, would be an important step forward. Regarding primary care, the fast development of a well-functioning network – indispensable for the reduction of geographic disparities in the provision of health services and for providing a "gatekeeper" to specialists and out-patient care – would depend largely on the incentive schemes for general practitioners and other medical personnel. International evidence suggests that a more diversified system of payments, including a fee-for-service component, would reduce waiting lists for elective surgery and raise the activity rates of physicians, while simultaneously ensuring that more attention is paid to patients' preferences. A move towards a more accountable hospital management, together with a pricing system and well-developed primary care would provide a better basis for containing costs while addressing shortfalls in the quality of health services. ■

What are the main options for reforming the pension system?

A major pension reform is urgently required primarily to ensure fiscal sustainability, but also to eliminate disincentives to work at older ages and enhance the effectiveness of the system in alleviating poverty. Pensions are mostly provided by a large number of earnings-related schemes. They are run by the public sector on a pay-as-you-go defined-benefit basis with practically complete coverage of the population. A defining characteristic of the pension system is the high degree of fragmentation both across sectors of employment and economic activity. While there is clearly a wide range of possible reform options, certain elements would seem to be key to any reform.

- On unchanged policies, spending on pensions is projected to increase to mid-century by most in the OECD. Reform is required not only to ensure fiscal sustainability, but also because otherwise pension outlays will account for more than one-fifth of unrevised GDP and inevitably crowd out other necessary social expenditure. A fall in pension benefits relative to average wages (through a lowering of the replacement rate and/or indexation to prices) will inevitably need to figure as one important element of any reform, although the extent of this adjustment can be limited by reforms which reduce disincentives to continue work in old age and by curtailing the many alternative early retirement pathways.
- Financial disincentives to continue working at older ages are among the highest in the OECD, and have led to a low employment rate among older workers. The pension system discourages continued work at older ages because of high statutory replacement rates, with tenuous links between contributions and benefits and a range of special provisions that allow early retirement before the "normal" retirement age of 65. Pensions should be linked to lifetime contributions to remove disincentives while the wide range of early retirement schemes should be phased out. The most blatant case for reform is the favourable conditions granted for early retirement from occupations which are classified as "arduous or unhygienic". There is a valid argument for preferential treatment when employment in a particular occupation leads to a lower life expectancy. However, the scale on which these provisions are currently granted (40% of all male retirees and 15% of female retirees, under the main employee pension fund) as well as the extensive list of occupations to which they apply, suggests that the current provisions go far beyond the aforementioned rationale. Once the normal age of retirement has been

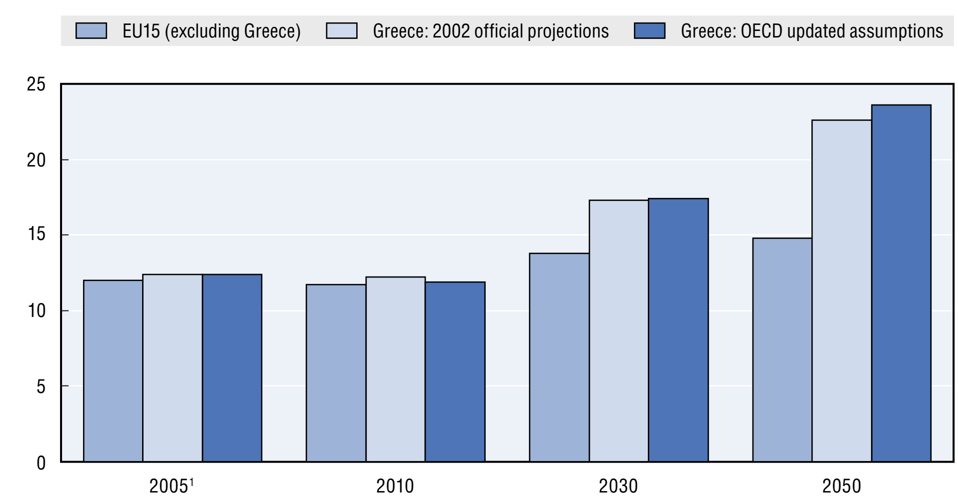
established as a genuine benchmark against which earlier or later retirement is judged and appropriately compensated, then consideration would need to be given to periodically increasing it in line with increases in life expectancy.

- Despite high aggregate pension outlays, the diversity in replacement rates across different funds means that pension expenditure is not always targeted to those most in need. Reducing overall pension expenditure while more effectively tackling poverty in old age is likely to mean that any safety net pension benefit will be available only at the official age of retirement in place of current minimum pension arrangements which severely distort incentives to retire early. There is a range of options for the safety net pension. It might, for example, be means-tested (to keep the fiscal costs down, but with potential adverse effects on savings) or alternatively could be universally available subject to legal residency requirements (though creating adverse incentives for immigration) or could even be based on current minimum pensions (but only available at the official age of retirement).
- The main pension system for the self-employed is similar in some respects to those for employees, but with important differences in the assessed earnings against which the pension is evaluated and contributions are determined. Assessed earnings are unrelated to actual earnings and instead correspond to notional income classes which, depending on the fund, increase with years of experience. The resulting share of social security contributions by the self-employed in aggregate appears low compared to their share in total employment, and also in comparison with other European countries. The implication is that notional income underestimates actual income, and that the implied lower cost of pension contributions is a problem because it represents a distortion in favour of self-employment over dependent employment (rather than a financial sustainability problem). Ideally it would make sense to switch the basis for self-employed pensions from notional to actual earnings or some proxy measure such as turnover. A prerequisite for such a change would be further improvement in the tax auditing of the

Figure 1.

LONG-TERM PROJECTIONS OF PENSION EXPENDITURE

In per cent of GDP



1. 2004 for EU15.

Source: European Commission (2006), "The Impact of Ageing on Public Expenditure", *European Economy*, Special Report No. 1, Economic Policy Committee and European Commission, Brussels; Ministry of Employment and Social Protection and Ministry of Economy and Finance (2005), "The Greek National Strategy Report on Pensions" and (2002) "The Greek Report on Pensions Strategy", Athens.

self-employed. If such a switch is not feasible, then the level of notional income bands against which the self-employed make contributions would need to be raised. ■

How can the functioning of the labour market be improved?

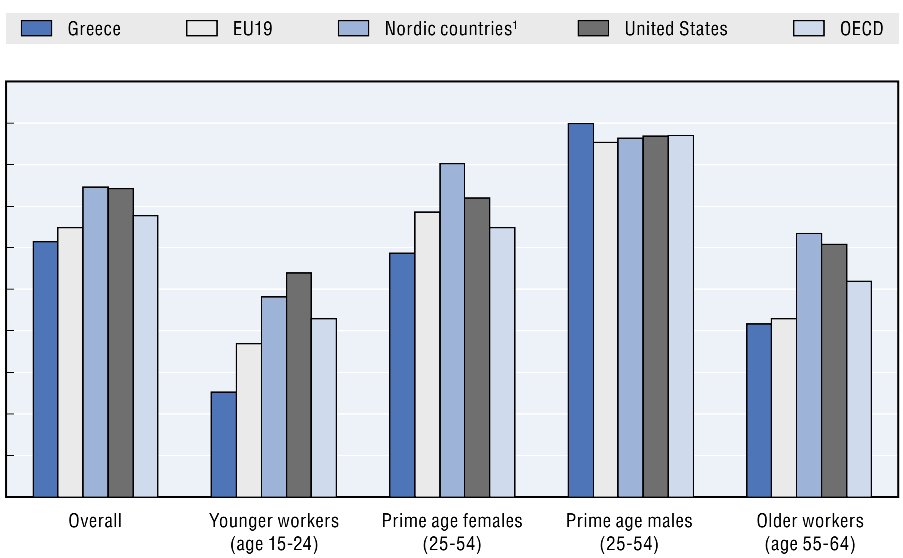
The standardised unemployment rate has fallen from a peak of 12% of the labour force in 1999 to around 9% in 2006, but still remains among the highest in the OECD. High unemployment is particularly prevalent among certain vulnerable groups, particularly first-time job seekers (mainly the young) and labour market re-entrants (mainly women); at the same time the unemployment rate for prime-age males is slightly below the OECD average, while it is double for prime-age females and the young. A range of other indicators – including the high incidence of long-term unemployment, low monthly outflows from unemployment, long average job tenure, and low gross labour flows between industries – suggest that labour mobility, broadly defined, is relatively low. There is scope for policy to improve labour market flexibility, such as actions that reduce minimum labour costs and ease the relatively strict employment protection legislation, although this is not currently on the government's reform agenda. Other important policy changes such as greater support for active labour market measures and childcare will probably have to await a further improvement in the fiscal situation. Greece will participate in the OECD school-to-work transition review, being reviewed during 2008, and this may shed further light on the appropriate policy responses to reduce the persistently high rate of unemployment among young people.

A recent OECD review of the available cross-country evidence suggests that, while minimum wages may sometimes play a useful supporting role in a broader anti-poverty programme, there is potential harm to job creation when minimum wage levels are high, particularly where no adequate allowance is made for youth and other vulnerable groups. For Greece, minimum wages, as a share of the median wage, are not exceptional in international comparison. However, the absence of a specific sub-minimum means that they do rank among the highest for youth. Minimum wages do differ by

Figure 2.

EMPLOYMENT RATES ARE LAGGING BEHIND

Employment as a percentage of population in the same age group, 2005



1. Denmark, Finland, Iceland, Norway and Sweden.

Source: OECD (2006), *Database on Labour Force Statistics*, October, *www.oecd.org/els/employment/stats*.

experience and family circumstances, but such differences do not appear to be sufficient to protect the most vulnerable groups. Any adverse effect on employment is exacerbated by relatively high social security contributions of employers which further increase the minimum cost of labour. An unusual, but not unique, feature is that legally binding minimum wages are set by the social partners and apply to the whole economy. Moreover, there is a close correlation between changes in minimum wages and average wages, suggesting that the process of setting minimum wages is closely integrated with aggregate wage determination. In setting minimum wages, the social partners should take into account high unemployment rates of youth and women. In order to reduce the minimum cost of labour, social security contributions for the low-paid should also be cut further, with this move being financed by public spending restraint. A more favourable treatment of low-income earners with families should be accomplished through the benefit system rather than through differentiated minimum wages. Given that unit labour cost increases have outstripped those in the rest of the euro area and thereby eroded competitiveness, the government should also consider ways to encourage more decentralised bargaining. This might be achieved by avoiding the administrative extension of collective agreements (at the industry or occupational level) to enterprises not represented in the negotiations. The government should continue to aim for more moderate increases in the wages of its own employees, as in 2005 and 2006, recognising that they often play a leading role in aggregate wage developments.

Employment protection legislation (EPL) across all occupations is roughly in line with the average for the other EU countries which are OECD members, but it is much stricter for white than blue collar workers, due to higher severance payments. While differentiated regulations for dismissals of white and blue collar workers are also in place in other OECD countries, this difference is much greater in Greece. This distorts the labour market, reduces labour market turnover and harms the employment prospects of groups which are most subject to entry or re-entry problems, such as the young, women and the long-term unemployed. Accordingly severance payments for white collar workers (especially those with relatively short tenure with the same employer) should be reduced and brought into line with those for blue collar workers. Consideration should also be given to bolder options, such as transforming severance pay legislation into a system of individual accounts as pioneered in Austria. Moreover, although the restrictiveness of EPL for temporary employment has decreased over the last decade, it remains among the most stringent in the OECD. Temporary employment can, however, be a first step towards career progression as it facilitates labour market entry for youth. Given the high rate of youth unemployment combined with the difficulties in entering the labour market, EPL on temporary employment should be reduced further. In addition, if temporary employment is to facilitate labour market entry, complementary reforms have to ensure that youth who start in temporary jobs move into permanent arrangements. Loosening EPL on temporary employment should hence be combined with reducing the level of protection for permanent workers. ■

What needs to be done in the tertiary education system?

Human capital needs to be raised through improvements to the education system. A particular priority is reform of tertiary education where Greece currently has one of the most centralised and least flexible systems in the OECD. This is reflected in the poor quality of tertiary education outcomes: graduation rates are low, studies take a long time and student drop-out rates are high. The government has recently enacted a reform, which includes a series of important measures which will improve the governance of universities, ensure independent evaluation, limit the duration of academic study and raise the provision of student loans. Regarding the establishment of private universities, the first constitutional hurdle has been passed, based on the government's majority in parliament, but an enhanced majority is still required after the election. While such changes appear modest in relation to how far Greece lags behind other OECD countries, they have met with great resistance, but are an essential step in the right direction. Such changes could lay the basis for further reforms, such as providing universities with greater autonomy in deciding on staffing and educational outputs and better governance. Private universities should be allowed as they would raise competition in the sector. The funding of universities should be linked to performance evaluations. Consideration should also be given to introducing tuition fees, which are currently only allowed for post-graduate studies, at a moderate level – rates of return to tertiary education are low in international comparison for men, but close to average for women. Tuition fees would raise the responsiveness of universities as well as injecting more resources into tertiary education, with likely gains to the quality of educational outcomes. The introduction of tuition fees should be accompanied by income-contingent loans to ease liquidity constraints faced by students from poorer families. ■

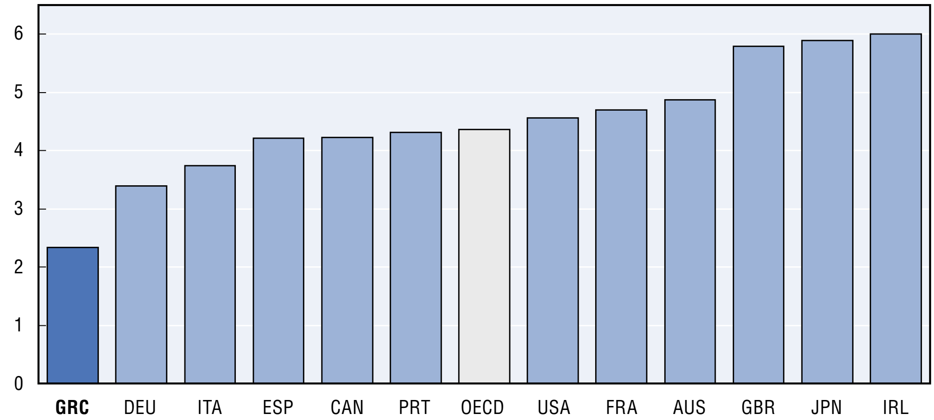
How can competition in the product market be enhanced?

While there has been considerable progress over the past decade, product market regulations which hinder competition remain stringent. This has held back productivity growth, inhibited inward foreign investment and contributed to a poor innovation performance. Specific areas where there is most scope for improvement include: reducing the number of procedures and the time taken for starting a business; easing regulation of professional services, which remains among the most restrictive in the OECD, especially because of licensing requirements and restrictions on fees or prices charged; easing regulation in the retail sector, which is among the most restrictive in the OECD due to licensing requirements, specific regulations relating to large outlets, protection of existing firms and regulation of shop hours; and eliminating discriminatory procedures that have been used to discourage

Figure 3.

GRADUATION RATES ARE LOW

New tertiary graduates as a share of the population aged 20-29, 2004[1]



1. Tertiary graduates cover all individuals, including those over age 29. OECD is an unweighted average.

Source: Oliveira-Martins, J. *et al.* (2007), "The Policy Determinants of Investment in Tertiary Education", *OECD Economics Department Working Papers*, forthcoming.

foreign investment. Positive steps in this direction have already been taken, such as on the development of large-scale tourist resorts and on the deregulation of shop hours.

Effective competition in the network industries remains weak. Many state-owned enterprises have been fully or partly privatised, but the stake of the government in key public utilities remains high, and price regulation is still pervasive, especially in the transport sector. Regarding energy, there has been considerable progress in transposing EU Directives in the electricity and gas markets into domestic legislation. Nevertheless, effective competition is still absent in the electricity market, despite the issuance of generation licenses, as the sector continues to be characterised by a high level of public ownership and vertical integration. The operations of the incumbents in the electricity and gas sector should be unbundled and non-discriminatory access to the grid secured. Cross-subsidies and preferential tariffs should be removed and licensing procedures for energy-related infrastructure eased. Last, but certainly not least, strong and effective regulators are critical in raising competition in the energy sector.

Competition has evolved more favourably in the telecommunications market with tangible benefits for consumers both, in terms of services provided and lower telephone charges. Access to broadband services is rapidly increasing, but remains very limited, as the unbundling of the local loop has progressed only little so far. Concerning the postal sector, the restructuring of Hellenic Post needs to continue to prepare it for privatisation. Universal service provision after the market is fully liberalised should be managed in a way that does not distort the market. Steps also need to be taken in the transport sector, where substantial regulatory challenges remain for road freight; barriers to entry and pricing restrictions should be eliminated. In the railway industry, reforms need to continue to establish a framework that will allow competition among several providers of railway services. On the other hand, there has been commendable progress in opening up the domestic ferry sector. ■

How can Greece sustain its strong growth performance?

This *Survey* presents a long list of recommendations that appear crucial for sustaining strong growth. Many, though not all of them, are on the government's reform agenda. Commendable progress has been made on fiscal consolidation and the government has also moved ahead in implementing structural reforms. Yet, much remains to be done. In the network industries or health care reforms, the crux lies in the effective implementation of the reform agenda. Similarly, Greece is slow in implementing European internal market directives into national law and faces a high number of infringement cases relating to poor quality transposition and/or incorrect application of internal market rules. At the same time, the government has to convince the public, which is often reluctant to embrace reforms, of the need to modernise and to move to international best practice. The current reform of the university system, for instance, was highly controversial even though it is essential. Moreover, the public still needs to be convinced of the required deep reform of the pension system that constitutes a *sine qua non* for achieving sustainable fiscal policy. Pushing ahead with reforms and their effective implementation will require a deep restructuring of the public sector. ■

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Economic Outlook No. 80, December 2006.
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