Greece: Staff Concluding Statement of the 2016 Article IV Mission

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A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

1. **Greece has made significant progress in unwinding its macroeconomic imbalances, but growth has remained elusive and risks are high.** Greece has managed to reduce its fiscal primary and current account deficits from double digits to around zero over the last six years. This is an impressive adjustment for a country belonging to a currency union, where policy levers are limited. The initial fiscal adjustment was based on important reforms. However, it has become increasingly reliant on one-off and ad-hoc adjustments that could not be sustained, denting policy credibility. Recurrent political crises and confidence shocks associated with the inability to sustain the reform effort resulted in a high cost for society, with output having declined by 25 percent and still stagnating, and unemployment and poverty rates remaining much higher than before the crisis. Looking forward, growth prospects remain weak and subject to high downside risks, and unemployment is expected to stay in the double digits until the middle of the century.

2. **Greece needs to pursue deep reforms in key areas to increase the economy's resilience and prosper within the currency union without long-term support from its European partners** . In the context of its new adjustment program, the authorities have laid the foundations for new reforms to shore up the public finances and support growth. But a significant deepening and acceleration of the pace of implementation of reforms is still necessary to address the four key structural problems that are hindering the recovery and pose considerable risk to long-term growth: (i) a vulnerable structure of the public finances resulting from unaffordable pension spending financed by high tax rates on narrow bases and a deteriorating payment culture; (ii) impaired bank and private sector balance sheets; (iii) pervasive structural obstacles to investment and growth; and (iv) a public debt burden that remains unsustainable despite large debt relief already received. Addressing these challenges decisively will be essential to achieve a better and more secure standard of living.

3. **As to fiscal policy, the structure of the budget should be improved through a rebalancing of the policy mix toward more growth-friendly policies.** In light of the impressive fiscal consolidation to date —not least the most recent fiscal package legislated in 2015-16—Greece does not require further adjustment to reach and maintain unprecedented primary surpluses, which would not only be detrimental to growth, but are also difficult to sustain in view of likely pressures given persistently high unemployment. However, the composition of the adjustment, which has relied on tax increases on narrow bases, adds significant risks to the budget and deters investment and employment. Spending remains exceedingly focused on unaffordable pensions provided to current retirees, which crowds out other needed social spending to protect vulnerable groups, including the unemployed. And essential public services have been cut to the bone, as evidenced by hospitals lacking syringes and public busses immobilized by lacking parts. A fiscally-neutral rebalancing of policies over the medium term toward lower pensions and a fairer distribution of the tax burden are thus essential for the public sector to able to provide adequate services and social assistance to vulnerable groups, while creating the conditions for investment and growth. Ongoing complementary reforms to modernize the public administration and public financial management should continue to be pursued with vigor. Looking forward, efforts should focus on two key areas:

- ***Social spending:*** Recent pension reforms aim to lower spending by about 1 percent of GDP in the medium-run. This is a welcome and undoubtedly politically difficult step in the current circumstances. However, it is well short of what is needed, considering that the deficit of the pension system remains highly unsustainable, at 11 percent of GDP (compared to an average of 2½ percent in the euro-area). The scale of the problem is such that the current policy of largely sheltering current pensioners while relying on much higher tax rates and lower expected pensions for current wage-earners is not consistent with sustainable growth and would become increasingly unsustainable on grounds of inter-generational equity. To create space for needed social spending to protect vulnerable groups and provide essential public services, a further reduction in current pensions is thus necessary and can be implemented by unfreezing current pensions and applying the new benefit formula. Relying instead on further across-the-board discretionary spending cuts, automatic or otherwise, should be avoided, as it is neither growth enhancing nor sustainable.

- ***Tax policies:*** A new income tax reform has helped to harmonize tax rates and generate additional fiscal savings, while a VAT reform has simplified the system. Nonetheless, the reforms largely rely on increasing tax rates, creating disincentives to work in the formal economy. Moreover, the income tax reform has not tackled Greece's very generous tax credit, which allows more than half of wage earners to be exempt from income taxes (compared to 8 percent in the euro-zone). Such exceptionally generous exemptions for the middle-class are difficult to justify with social-fairness arguments, as they forego the revenues needed to protect the most vulnerable through welfare and unemployment benefits that are common elsewhere in Europe. In this context, the authorities should reduce tax (and social security contribution) rates, while lowering the generous income tax credit and eliminating remaining exemptions that benefit the rich. Such a policy can also ultimately result in a more equitable distribution of the tax burden.

1. **To support their fiscal rebalancing strategy, the authorities should send a strong signal that Greece can no longer tolerate evasion** . The policy of repeatedly hiking already high tax rates has prompted a proliferation of installment and deferral schemes (more than 60 social security schemes have been put in place since 2001). Their frequency and the inability to enforce them suggest that they are inevitably seen as de facto tax forgiveness. This is evidenced by the rapidly accumulating tax and social security debt (70 percent of GDP, the highest in the euro-zone, which is owed by half of taxpayers). It is also borne out by the deterioration in tax-collection rates (the percentage of the annual assessment that is collected), which have fallen from an already low level of some 75 percent in 2010 to less than 50 percent now despite unprecedented international technical assistance. Tax evasion by the rich and the self-employed and an ineffective and politicized tax administration have contributed to the problem, putting undue pressure on the budget and leading to an unequal distribution of the tax burden. It is thus critical that the authorities refrain from adopting further installment schemes. Instead, they should put in place tailored and durable restructuring solutions for viable debtors in line with their capacity to pay, concentrate audits on large taxpayers and high net-wealth individuals, and continue to strengthen the use of enforcement tools against those who can but do not pay. Implementing the recently legislated independent revenue agency fully insulated from political interference will be critical in this effort.

2. **Non-performing loans (NPLs) must be reduced rapidly to create the conditions for a resumption of credit to the economy.** NPLs have reached close to 50 percent of total loans, the second highest level in the euro-area. This reflects not only the effects of the economic downturn on individuals' and businesses' capacity to pay, but also a weak payment culture. Assuming that banks can grow out of the NPL problem is not credible, as growth ultimately depends on lending to dynamic enterprises, which is constrained if banks instead keep alive unproductive and indebted ones. Putting in place policies that support a rapid clean up of bank balance sheets is thus critical to achieving a successful recovery. This requires building on recent efforts to further strengthen and fully implement the legal tools for debt restructuring to restore the payment culture and provide incentives for borrowers and creditors to resolve NPLs. The supervisory authorities should continue to strengthen incentives for banks to set ambitious NPL-reduction targets and implement strategies prioritizing sustainable restructuring measures and NPL sales. Ensuring adequate bank capital is key to allow a rapid reduction in NPLs, even if costly.

3. **At the same time, payment conditions should be normalized and bank governance strengthened** . Payment restrictions and capital controls persist, hindering confidence and the return of much needed liquidity to the economy. The authorities should relax the controls rapidly and predictably—on the basis of a milestone-based roadmap—while preserving financial stability. Moreover, lingering governance concerns, related to a legacy of close relations between banks, the state, and powerful vested interests, foster an inefficient allocation of resources toward well-connected but unproductive entities. The authorities should follow up on recent legislative steps to strengthen governance by severing the links between the banks and the political system in both systemic and non-systemic banks and improving bank-management standards by taking advantage of international expertise. Relying on public development banks to engineer growth risks leading to an inefficient allocation of resources and ultimately higher taxpayer costs.

4. **Structural reforms must be accelerated to boost competitiveness and growth.** Despite successive attempts to address its weak institutions, Greece has not managed to regain competitiveness, with productivity growth among the lowest in the euro-area, investment down by more than 60 percent, and export growth lagging peers. The 2011 labor market reforms to collective bargaining and the minimum wage were major steps forward, as evidenced by the subsequent and notable improvement in labor costs. However, in the absence of product-market reform implementation, the burden of the adjustment has been borne largely by wage earners. The resistance to labor market reforms is thus understandable. But it would be wrong to conclude that labor market reforms should be reversed, as this would risk the potential gains for investment and job creation. Instead, the reforms should be complemented with more ambitious efforts to implement ongoing reforms to fully open up remaining closed professions, foster competition, and facilitate investment licensing and privatizations, as well as with measures to bring Greece's collective-dismissals and industrial-action frameworks in line with international best practices.

5. **Even with full implementation of this demanding policy agenda, Greece requires substantial debt relief calibrated on credible fiscal and growth targets** . Despite very generous debt relief from private and official creditors, debt has continued to rise, reaching unsustainable levels. This reflects significant shortfalls between economic outcomes and Greece's ambitious targets under its past adjustment programs. The authorities' current targets remain unrealistic, in that they still assume that Greece will attain and sustain primary surpluses of 3½ percent of GDP for many decades—despite double-digit unemployment rates until the middle of the century—and at the same time achieve high growth rates. In this context, it cannot be assumed that Greece can simply grow out of its debt problem. Further debt relief will be required to restore sustainability, going well beyond what is currently under consideration, and it should be calibrated on realistic assumptions about Greece's ability to generate sustained surpluses and long-term growth.

6. **Greece is at a crossroads, and bolder efforts are needed to address its remaining key challenges** . Without a doubt, Greece has made enormous sacrifices to get to where it is now. But the significant achievements in balancing the budget, closing the current account deficit, and improving the flexibility of the labor market have taken a heavy toll on the society and tested its endurance. The recent humanitarian challenge caused by the flow of refugees into Europe has added to the burden on the Greek people. This calls for the full support of Greece by its European partners. While Europe has already demonstrated its support by providing Greece with the time needed to adjust, further debt relief remains essential. Greece, for its part, should seize the opportunity to make steady but resolute progress toward addressing its remaining challenges.

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The mission is grateful to the authorities for the constructive discussions