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Focus-Greece

2011 draft budget: deficit target deemed attainable

Highlights

- **The 2011 draft budget targets a reduction of general government budget deficit to 7.0%-of-GDP, from 7.8%-of-GDP expected this year**
- **This is a lower deficit target than projected in the EU/IMF program, signaling the government's strong commitment to aggressive fiscal consolidation**
- **A careful analysis of the main items of the 2011 draft budget reveals that its main revenue- and expenditure-side targets are perfectly attainable under a wide range of realistic assumptions about the domestic macroeconomic environment**
- **The new budget applies measures worth 3.9ppts-of-GDP to attain a projected deficit reduction of 0.8ppts-of-GDP. The latter implies a sizeable cushion incorporated in the new budget to address implementation and macroeconomic risks**

2011 draft budget: main parameters and assessment

The Greek government unveiled yesterday its pre-budget for 2011. Passing the final bill in Parliament requires absolute majority and thus, we expect no major problems in the parliamentary vote in late December, as the leading party controls 157 out of a total of 300 seats. The new budget targets a reduction of the general government budget gap *(ESA 1995 definition)* to 7.0%-of-GDP in 2011, from an expected deficit realization of 7.8%-of-GDP this year.

It is important to note that both next year's target and the expected deficit outcome in 2011 are somewhat lower than the deficit projections specified in the EC/ECB/IMF memorandum of understanding (MoU) agreed with Greek authorities in early May *(8.1%-of-GDP in 2010 and 7.6%-of-GDP in 2011).* This does not come as a major surprise as a number of reports circulated in the local press over the last couple of weeks suggested that the government was likely to set a more ambitious fiscal target for next year relative to that envisioned in the May 2010 MoU. Nonetheless, to the extent that such a relative outperformance is deemed realistic (as we firmly believe so) we interpret it as a very encouraging sign about the government's commitment to aggressive fiscal consolidation.

The new budget is framed on an adverse domestic macro environment, envisioning a continuation of the economic recession next year. Specifically, real GDP growth is expected to contact by 2.6% in 2011 following a 4% decline this year, while the unemployment rate is expected to climb further, reaching 14.6% of the labor force next year, from 11.8% in Q2-2010. On the other hand, domestic inflation is expected to remain elevated during the remainder of this year, with the annual CPI rate averaging 4.6% in 2010 and 2.2% in 2011.

These macro forecasts are similar to those envisioned in the baseline scenario of the EU/IMF stabilization program and are deemed to be broadly realistic, even though the government believes that the 2010 pace of output contraction may prove slightly milder that -4% *(a forecast of -3.5% was quoted recently by the Finance Minister),* thanks to a stronger-than-expected Q1 GDP reading and a recent tentative improvement in a range of higher-frequency indictors of domestic economic activity *(also see analysis below).*

Table A on page 4 contains a detailed depiction of the main parameters of the 2011 draft budget *(in million euros and in percentage points-of-GDP terms).* Column (a) corresponds to 2009 realizations; column (b) contains this year's targets implied by the May 2010 MoU; column (c) shows the estimated fiscal realizations for 2010 as they appear in the 2011 draft budget; and column (d) presents the fiscal targets for next year.

A number of points related to table A deserve some special analysis. First of all, the growth projection for ordinary budget revenue in 2010 has been revised down to 7.3% YoY, from 12.3% YoY in the May 2010 MoU *(see line a.).* That is to bring the corresponding annual target more in line with the year-to-date *(realized)* performance of this broad budgetary revenue category. Specifically, the latest data for the central government budget execution showed ordinary revenue growth of only 3.4% YoY over the first eight months of this year, with the underperformance relative to corresponding official target being due to, among other factors, weaker-than-expected VAT receipts. The latter amounted to €11.54bn in January-August 2010, compared with a target of €19.01bn for the full year.

The government expects a pick up in the growth of VAT revenue in H2-2010, given that the latest installment of VAT rate hikes and increases in a range of special consumption taxes on cigarettes, alcoholic beverages, fuels and various luxury items did not come into effect until July 1, 2010. Indeed, the August data showed an acceleration in the growth of VAT receipts to 10.8% YoY from -3.9% YoY in the prior month, while according to the finance ministry, this important revenue category recorded growth of 16.9% YoY in September *(official data not out yet).*

Besides a wide range of measures introduced earlier this year to boost tax revenue, the government expects budgetary receipts to derive further support in the following months by a number of additional measures, which, among other items, include a new scheme to settle outstanding tax liabilities to the state. The latter scheme is expected to become operational before year-end and to bring some €3.5bn (1.5pps-of-GDP) of additional inflows to state coffers over the next 12 months *(official forecast).*

For 2011, the carry over impact of measures introduced in 2010 along with a new range of revenue-boosting items envisioned by the May 2010 MoU and the 2011 draft budget are expected to continue supporting budgetary receipts and as such, we deem the corresponding official projections/targets for both this year and the next to be broadly realistic. Note that the full impact of higher corporate and personal income tax rates as well as the new tax thresholds introduced with the new tax law *(voted in parliament before the announcement of the EU/IMF bailout package)* will only start having a full impact on government accounts from January 2011 onwards.

On the expenditure side, the -9.2% YoY growth projection of the draft budget for ordinary budget primary expenditure appears perfectly realistic, if not conservative, given the strong reduction in this *broadly* *inelastic* expenditure category over the first eight months of this year *(-12.5% YoY vs. a -5.8% YoY full-year target).* This strong performance should not come as a major surprise, given that the total government bill for wages and pension has been reduced by as much as 15% YoY in 2010. In view of these developments, we have little doubt that the government will also be able to attain next year's target for primary spending *(-1.5% YoY).*

Now, with respect to interest payments, we deem the draft budget's projection for 2011 (+19.6% YoY) to be realistic, given that it is relatively easy to derive reliable forecasts about this particular spending item, especially as the government is expected to cover most of its roll-over and budget-financing needs for next year by utilizing funds under the existing EU/IMF lending facilities. In percentage-of-GDP-terms, interest rate expenditure is projected to reach 6.8% in 2011, up from an estimated 5.6% in 2010 and 5.2% in 2009.

With respect to the public investment budget (PIB), the 2011 draft targets growth of 30.1% YoY in PIB revenue along with a 3.3% YoY reduction in public investment expenditure. The imminent introduction of a new framework aiming to speed up absorption of EU structural funds *(structural benchmark for Dec. 2010)* is expected to boost state receipts and, in addition, the government can always contain investment expenditure by more than expected to meet any unforeseen gaps in the 2011 budget.

Past experience has shown that it is much more difficult to make accurate predictions about the evolution of some of the budgetary aggregates recorded in the lines 6a-6d of Table A (sub-government sector). The latter has been partly due to the lack of timely official fiscal statistics for the broader public sector *(local governments, social security funds, public hospitals and other state controlled entities).* However, this is going to change in the near future given that, from now on, Greece will hav to publish timely official statistics for the broader public sector as well *(structural benchmark for September 2010, under the EU/IMF program).* Moreover, a wide range measures for reducing waste in the broader public sector is expected to facilitate attainability of the respective official targets for next year[1].

Finally, the general government debt stock is expected to reach 142.2%-of-GDP in 2011, from 132.7%-of-GDP in 2010 and 115.4%-of-GDP in 2009. We expect the debt ratio to stabilize at levels around 145% -of-GDP in 2012, before a gradual de-escalation is realized thereafter. Note also, that the general government primary position is expected to be broadly balanced in 2011 (-0.2%-of-GDP), comparing to sizeable primary deficits in the prior two years (2009: -8.6% 2010 & -2.2%-of-GDP in 2010).

Regarding the thrust of fiscal adjustment for next year, it is important to note that the fiscal measures specified in the 2011 draft budget are estimated to be worth 3.9ppts-of-GDP (= 0.6ppts-of-GDP expenditure-side measures + 2.3ppts-of-GDP revenue-boosting measures + 1.1ppts-of-GDP expected carry over from measures introduced in 2010). That is to facilitate a targeted reduction in the general government budget deficit of only 0.8ppts-of-GDP. This implies that a significant cushion is incorporated in the new budget to address any implementation slippages and/or risks of a more significant than expected contraction in real GDP growth next year.

[1] For more analysis on government measures to reduce waste in the broader public sector see *Eurobank EFG Research, "The Greek Economy and its Stability Programme", June 2010.*

Table A: 2011 budget draft - fiscal targets

In € mio	2009	2010	2010e	2011	% Change		
		EU/IMF program					
1. Ordinary Budget	(a)	(b)	(c)	(d)	(b) / (a)	(c) / (a)	(d) / (c)
a. Current revenue	52,308	58,744	56,144	59,313	12.3%	7.3%	5.6%
a1. Tax returns	4,952	5,100	5,100	4,800	3.0%	3.0%	-5.9%
a2. Extraordinary revenue	1,135	1,480	1,656	1,827	30.4%	45.9%	10.3%
a3. Net ordinary budget revenue (a-a1+a2)	48,491	55,124	52,700	56,340	13.7%	8.7%	6.9%
b. Ordinary budget expenditure (b1+b2+b3)	71,810	67,873	66,187	67,650	-5.5%	-7.8%	2.2%
b1. Interest payments	12,325	13,017	13,209	15,800	5.6%	7.2%	19.6%
b2. Primary expenditure	57,987	54,611	52,633	51,850	-5.8%	-9.2%	-1.5%
b3. Payments for thesettlement of outstanding hospital debts	1,498	245	345		-83.6%	-77.0%	
2. Ordinary budget balance (1a3-b)	**-23,319**	**-12,749**	**-13,487**	**-11,310**	-45.3%	-42.2%	-16.1%
3. Public Investment budget (PIB)							
a. Revenue	2,041	3,258	3,015	3,922	59.6%	47.7%	30.1%
b. Expenditure	9,588	9,200	9,000	8,700	-4.0%	-6.1%	-3.3%
4. PIB balance (3a-3b)	**-7,547**	**-5,942**	**-5,985**	**-4,778**	-21.3%	-20.7%	-20.2%
5.central government balance (2+4)	**-30,866**	**-18,691**	**-19,472**	**-16,088**	**-39.4%**	**-36.9%**	**-17.4%**
5a. Central gvnt primary balance (5+1b1)	-18,541	-5,674	-6,263	-288	-33.8%	-29.7%	2.2%
6. Sub-government sector (6a+6b+6c+6d)	**-1,886**	**-31**	**964**	**-196**			
6a. Budget balances of local governments, social security funds & other public entities	1,338	2,669	2,351	2,600			
6b. Transfers to various public entities	-531	-550					
6c. Defense expenditure	-2,919	-2,700	-1,100	-1,400			
6d. National accounts adjustments	226	550	-287	-1,396			
7. General government budget balance (5+6)	**-32,752**	**-18,722**	**-18,508**	**-16,284**	**-42.8%**	**-43.5%**	**-12.0%**
7i. General government budget balance (% GDP)	*-13.8%*	**-8.1%**	**-7.8%**	**-7.0%**			
Nominal GDP (EURbn)	237,494	231,000	236,100	323,100			

Source: 2011 budget draft; Eurobank Research

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