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Focus Greece:

2011 budget: Main targets & assessment

Greece's 2011 budget - Main targets and analysis

The Greek government unveiled earlier today its final budget plan for 2011. Passing the final bill in Parliament requires absolute majority and thus, we expect no major problems in a parliamentary vote on December 22, as the leading party controls 157 out of a total of 300 seats. The new budget targets a reduction in the general government deficit *(ESA 1995 definition)* to 7.4%-of-GDP in 2011, from an *(upwardly-revised)* deficit forecast of 9.4%-of-GDP this year.

In nominal terms, the overall fiscal deficit is expected to decline to ca €16.8bn next year, from €21.9bn in 2010. The latter effectively means that the government will aim to bring next year's deficit back in line with the terms of the existing EC/ECB/IMF bailout deal. To assist attain the 2011 deficit targets, the new budget incorporates a number of additional austerity measures *i.e., beyond these already included in the revised Memorndum of Understanding (MoU) with the troika*. The government estimates these additional measures to be worth 2.7pp-of-GDP, bringing the total expected thrust of the 2011 austerity package to 6.4pp-of-GDP *(=2.7pp-of-GDP + 1.2pp-of-GDP carry over from measures taken earlier this year + 2.5pp-of-GDP measures for 2011, incorporated in the MoU).*

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 now expected to contact by 3.0% in 2011 following a 4.2% decline this year, while the unemployment rate is forecasted to climb further, reaching 14.6% of the labor force, from levels around 12% in 2010. On the other hand, domestic inflation is expected to remain at elevated levels for the remainder of this year, with the annual CPI rate averaging 4.6% in 2010 and 2.2% in 2011.

Table A on page 5 shows the main targets and expected realization of the new budget in nominal and ppt-of-GDP terms. Column (a) corresponds to 2009 realizations; column (b) contains this year's targets as they appear in the *revised* MoU; column (c) shows the estimated fiscal realizations for 2010 as they appear in the 2011 budget plan; and column (d) presents the fiscal targets for next year. A few points related to table A deserve some additional analysis.

First of all, the growth projection for ordinary budget revenue in 2010 has been revised down to 4.9% YoY from 7.3% YoY in the initial budget draft for next year and 12.3% YoY in the May 2010 MoU *(see line a of Table A).* That is to bring the corresponding annual target more in line with the year-to-date performance of this important budget category. Specifically, the latest available data for the execution of central government budget shows ordinary budget revenue growth of only 3.6% YoY in the first ten months of 2010, with the underperformance relative to the earlier full-year target being due to, among other factors, reported delays in **i)** the collection of personal income and corporate tax payments, **ii)** the collection of outstanding arrears to the state, related to a special tax on real estate assets in the period 2008-2009 and **iii)** a new tax on real estate introduced this year. On a more positive note, VAT receipts, which constitute around 1/3rd of total ordinary budget revenue, are estimated to have bounced strongly recently, growing by an average 14.3%YoY in Q3, following broadly flat growth in H1. For the first ten months of the year, VAT revenue is up 4.4% YoY cumulatively, assisted by **a)** higher VAT tax rates relative to the same period a year earlier, **b)** strengthened government efforts to track down tax evasion in domestic retail establishments and **c)** the linking of tax-exempt thresholds in personal income statements with the submission of retail sales receipts, which led to a drive of domestic consumers earlier this year to collect sales receipts.

Secondly, the growth target for ordinary budget revenue next year has also been revised down to 4.9% YoY, from 5.6% YoY envisioned in the initial 2011 draft budget. Presumably, the revision aims to bring the corresponding target more in line with a higher-than-previously-expected contraction in real GDP growth next year *(-3% YoY vs. -2.6% YoY seen in the preliminary budget draft).* In needs to be noted, however, that *net* ordinary budget receipts in 2011 are now projected to growth faster than expected in the initial budget draft *(+8% YoY vs. 6.9% YoY)*. The latter is mainly because the government now expects next year's tax returns to be lower (by ca 0.43pp-of-GDP) relative to what was envisioned in the initial budget draft.

On the expenditure side, the budget's -9.0% YoY growth projection for ordinary budget primary expenditure this year appears perfectly realistic, if not conservative, given the strong reduction in this *broadly inelastic* expenditure category over the first ten months of 2010 *(-11.6% YoY).* This strong performance should not come as a major surprise, given that the total government bill for wages and pension has been cut in 2010 by as much as 15% YoY. The corresponding growth target for next year (-0.3% YoY) is also deemed realistic, in view of the expected freeze in public-sector wages and pension costs. However, overall ordinary budget expenditure is expected to increase by 4.3% YoY in 2011, as a result of higher interest costs relative to the current year. One would probably like to see more aggressive cost reductions in the more elastic components of the ordinary budget *(e.g. operating government expenditures)* so as to help partly offset higher servicing costs. In any case, the corresponding spending targets for the government's ordinary budget appear overall attainable, and broadly in line with our forecasts.

With respect to public investment budget (PIB), the new draft budget targets growth of 35.6% YoY in PIB revenue along with broadly flat growth in public investment expenditure. The recent introduction of a new framework aiming to speed up absorption of EU structural funds *(structural benchmark for Dec. 2010)* is expected to facilitate state receipts under the PIB budget. Naturally, the government can always contain investment expenditure by more than expected to meet any unforeseen gaps in the 2011 budget.

Now, with respect to interest payments, we deem the new budget's projection for 2011 (+20.1% YoY) to also be realistic, given that is relatively easy to derive reliable forecasts for this particular spending item, especially as the government is expected to cover most of its roll-over and budget financing needs next year via the utilization of funds under the existing EU/IMF lending facility. In percentage-of-GDP-terms, interest rate expenditure is projected to reach ca 7.0% in 2011, from 5.7% this year.

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-6c of Table A (sub-national sectors & national accounts adjustments). This has been partly due to the lack of reliable and timely official statistics for the accounts of local governments, social security funds, public hospitals and other state controlled entities. However, to a large extent, this has problem has been recently addressed as, starting in October 2010, Greece began to publish timely official statistics for the broader public sector *(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. Note finally that a number of methodological changes on how to record fiscal balances of entities in the broader public sector have already being made in consultation with the Eurostat. As such, assuming that the economy's main macro variables evolve broadly in line with the new budget's underlying assumptions, we expect any overruns at the sub-national budget level to be manageable and potentially offset by cutting other expenditure items in the central government budget.

As we noted already, the new budget incorporates a number of additional austerity measures - *beyond these already included in the revised Memorndum of Understanding (MoU)* - in order to facilitate the attainability of the 2011 fiscal deficit target. These new measures are estimated to be worth 2.7ppts-of-GDP, out of which 1%-of-GDP corresponds to revenue-side measures and 1.7ppts-of-GDP to expenditure-side measures. The three biggest items of this additional package include: **a)** additional measures to track down tax evasion (expected impact: 0.7ppts-of-GDP), **b)** further reduction in health-related expenditure (expected impact: 0.9ppts-of-GDP) and **c)** additional cost-cutting in public corporations (expected impact: 0.4ppts-of-GDP). A quick assessment of the extra measures noted above is that the government would probably need to address the high cost structure and existing waste in state controlled corporation (DEKO) in a more aggressive way.

Finally, the general government debt stock is expected to reach 152.6%-of-GDP in 2011, from 142.5%-of-GDP in 2010 and 126.8%-of-GDP in 2009. Note also that the general government primary position is expected to be broadly balanced in 2011 (-0.4%-of-GDP), comparing to sizeable primary deficits in the prior two years (2009: -10.1% 2010 & -3.7%-of-GDP in 2010).

Our assessment

Overall, we believe that the 2011 fiscal deficit target is attainable, under the following two conditions: a) the contraction in real GDP growth will not be significantly higher than the budget's underlying assumption (-3% YoY) and b) the government will be in a position to fully implement the measures envisioned in the 2011 budget.

In support of the latter view, we note the following:

a) **The 2011 budget applies measures estimated to be worth as much as 6.4ppts-of-GDP in order to promote a targeted fiscal adjustment of 2ppts-of-GDP** *i.e., to reduce the general government budget deficit from an estimated 9.4%-of-GDP in 2010 to 7.4-of-GDP next year.*

b) **Notwithstanding the recent revisions to 2006-2009 fiscal data (and the fiscal projections for this year), the government expects to accomplish an overall fiscal adjustment of ca 6ppts-of-GDP this year, which compares with a 5.5ppts-of-GDP deficit reduction envisioned in the EC/ECB/IMF program.**

c) **The silver lining in the announced revisions to Greece's past fiscal data is the lifting of Eurostat's reservations on the country's past fiscal data as expressed in the April 2010 notification.**

d) **In a public address following the announcement of the results of the 2nd round of local elections, Prime Minister, George Papandreou, emphasized his government's commitment to exhaust its full four-year term in power and reiterated his strong commitment to the EU/IMF-backed reforms. This effectively puts the risk of early elections off the table, at least in the foreseeable future. The latter constitutes a very important development in our view, given that a credible commitment by**

the government on fiscal reforms is key for influencing market perceptions about medium-term fiscal sustainability.

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Table A: 2011 Budget - 2010 estimates and 2011 targets							
	2009	**2010** EU/IMF program	**2010e**	**2011**	**% Change**		
In € mio	**(a)**	**(b)**	**(c)**	**(d)**	**(b) / (a)**	**(c) / (a)**	**(d) / (c)**
1. Ordinary Budget							
a. Current revenue	52,308	58,744	54,853	57,520	12.3%	4.9%	4.9%
a1. Tax returns	4,952	5,100	5,100	3,800	3.0%	3.0%	-25.5%
a2. Extraordinary revenue	1,190	1,532	1,681	1,840	28.7%	41.3%	9.5%
a3. Net ordinary budget revenue (a-a1+a2)	48,546	55,176	51,434	55,560	13.7%	5.9%	8.0%
b. Ordinary budget expenditure (b1+b2+b3+b4)	74,626	69,725	68,893	71,839	-6.6%	-7.7%	4.3%
b1. Interest payments	12,325	13,017	13,260	15,920	5.6%	7.6%	20.1%
b2. Primary expenditure	57,992	54,611	52,798	52,633	-5.8%	-9.0%	-0.3%
b3. Payments for thesettlement of outstanding hospital debts	1,498	245	345	450			
b4. Other expenditure (includes called state guaranties on public corporations' debts)	2,811	1,852	2,490	2,836			
2. Ordinary budget balance (1a3-b)	**-26,080**	**-14,549**	**-17,459**	**-16,279**	-44.2%	-33.1%	-6.8%
3. Public Investment budget (PIB)							
a. Revenue	2,040	3,258	2,892	3,922	59.7%	41.8%	35.6%
b. Expenditure	9,588	9,200	8,500	8,500	-4.0%	-11.3%	0.0%
4. PIB balance (3a-3b)	**-7,548**	**-5,942**	**-5,608**	**-4,578**	-21.3%	-25.7%	-18.4%
5.central government balance (2+4)	**-33,628**	**-20,491**	**-23,067**	**-20,857**	**-39.1%**	**-31.4%**	**-9.6%**
6. Broader public sector (6a+6b+6c)	**-2,521**	**1,769**	**1,167**	**4,024**			
6a. Budget balances of local governments, social security funds & other public entities	-2,365	2,669	-851	1,491			
6b. Transfers to various public entities	-531	-550		-420			
6c. National accounts adjustments	375	-350	2,018	2,953			
7. General government budget balance (5+6)	**-36,150**	**-18,722**	**-21,900**	**-16,833**	**-48.2%**	**-39.4%**	**-23.1%**
7i. General government budget balance (% GDP)	*-15.4%*	*-8.1%*	*-9.4%*	*-7.4%*			
General gvnt primary balance	-23,825	-5,705	-8,640	-913			
General gvnt primary balance (% GDP)	-10.1%	-2.5%	-3.7%	-0.4%			

Source: FinMin, Eurobank Research

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