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PUBLIC FINANCE: GREECE AND THE EEC

By NICHOLAS V. GIANARIS*

The main questions of governmental economic policy in our days are: 1) what is the optimum size of the public versus the private sector, if any, and 2) how to finance governmental services in such a way that additional expenditures (marginal costs) for each public purpose equal additional or marginal benefits. Although there is strong criticism against public spending in Western countries, including Greece, it has been proven that, as income increases demand for government services increases. And this, despite the fact that private industry spends a great deal in advertising expenditures in order to create new and more intense wants for private goods. The demand for public services includes, among other social necessities, social security and medical services, education, defense, administration of justice, and domestic security. If such public services are insufficient and of poor quality, the private sector and the economy as a whole will not perform well.

Considering the three main alternative means of financing public expenditures, that is, taxation, bond issuance, and money creation, it would seem that the first alternative is the most anti-inflationary for the Greek economy. Money creation on the other hand is clearly inflationary when it exceeds the real rate of economic growth, given that velocity is also high in present days; while government bond issuance is not widespread in Greece.

It seems that public finance plays a significant role in investment policies, inflationary trends and income distribution, especially in Greece. The occasional and temporary nature of the governmental economic policy, similar to the housing policy of Athens, created a serious structural problem in the Greek economy. Such a policy, affected by the sociopolitical instability of the country in the postwar years, led to a swollen tertiary sector at the neglect of the secondary (especially manufacturing) and, to some extent, the primary the sector. As a result, a large class of

* Associate Professor of Economics and Economics Program Coordinator, Fordham University, Lincoln Center, New York. While I alone take the responsibility for my paper, I acknowledge debt to Professors Solomon Fabricant, John Roche, Gus Papoulia, and Richard Kjetsa for their valuable comments.

middlem and self-employed persons in services was created. Their average income is almost double (311, 800 drachmas in 1976) that of salaried persons and farmers (170, 400 drachmas). These high incomes result primarily from high profits realized by oligopolistic distributors and traders, and are mostly spent in unproductive, quick-profit-making ventures, such as speculation on urban lots or apartments, and imported luxury goods, which, in turn, increase inflation. Or, they increase the demand for mainly consumer goods, pulling prices up, without offering much to increase productivity. Moreover, employment in many tertiary services, such as tourism and trade, is seasonal and occasional.

These trends, supported by public finance during the postwar years, allow the Greek economy to look good on the surface, although it is actually weak in its structure. Under stable international and domestic conditions, that economy can continue its good performance as long as the invisibles (mainly from tourism and shipping) provide sufficient amounts to pay for its ever-increasing imports. In the case of disturbances, however, the reduction of invisibles would place the economy in a precarious position. On the other hand, the extensive use of foreign (mainly immigrant) deposits to finance imports of consumer goods would add another element of potential disturbance to the economy if large withdrawals were to occur. Moreover, immigrant remittances, which help stabilize the balance of payments and the credit position of the country, may exaggerate, at the same time, the inflationary nature of the economy, in so far as they are used for wasteful consumption and other unproductive urban ventures, and perpetuate the parasitic way of life in a large segment of the population.

Already, imports have increased significantly to the extent of even substituting domestic production for certain products. And this, despite the fact that the drachma has been gradually devaluated, in an amount at least equal to the dollar's devaluation. It is expected that this policy of devaluation would increase exports and decrease imports, since Greek products would be cheaper for other countries and foreign products more expensive in Greece. However, the continuous increase in imports of luxurious or semiluxurious products, which push also the overall price index upward (imported inflation), indicates that the economic policy of the government should turn towards increasing productivity and reducing or holding the incomes of those persons (mainly middlemen) whose spending is directed towards imports of such unnecessary consumer goods.

It is obvious that the Greek economy needs structural changes toward industrialization and improvement in the public sector. The country's accession to EEC is expected to speed up such structural changes in a number of sectors, including the public sector, which absorbs about one third of the total economic activities. From that point of view, Greece cannot afford to walk; She has to run in the foreseable future.

After the accession, the economy would be more open to international or Common Market competition. This means that if Greece is unable to achieve the desired structural changes and improve her industrial position, she might be forced to specialize even more in the tertiary sector. Competition is expected to be more intensive after the complete elimination of tariffs on imports from the EEC for such protected produts as clothing, footware and metals (which vary now from 15 to 44 percent), as well as the reduction of tariffs on similar imports from third countries to those levied by the EEC.

Consequently, the government and the financial institutions, in exercising their fiscal and credit policies, should emphasize productive investment, mainly in the manufacturing and the exporting sectors. The fact that labor is cheaper and capital more productive in Greece than in the other EEC countries, such investment would probably make successful in reducing inflation and improving the balance of trade of the country. Perhaps investment in entrepreneurial and technical training is the most promising endeavor to be pursued by the public policy of the country, both for long term employment and higher productivity.

From the viewpoint of the public sector, the accession to the EEC would bring some limitations on matters of policy making, not only on tariffs and foreign trade but also on a number of domestic economic policies, such as adjustment of taxes, elimination of export subsidies, budgetary appropriations, exchange rate fluctuations, and the like. The value added tax, in the place of the turnover tax, is a case in point. Given that the laws and regulations of the Community prevail on member–nations, Greek laws on taxation and related matters would adhere to those of the EEC after full membership.

The Value Added Tax (VAT), which was introduced first by France in place of major business taxes, is defined as a tax upon the difference between the total value of output minus the value of purchased material inputs. It taxes all factors of production, including labor, and encourages substitution of capital for labor and transfer of capital from declining industries to the successful sectors and enterprises. Moreover, without distorting the efficient allocation of resources, it helps policy makers to determine whether demand for consumer goods is growing in an inflationary way. However, additional value added taxes themselves would, more likely, pass on to the consumers by rising prices.

The VAT, or consumption tax, as it may be called, was adapted by the 1st and 2nd Directives of the EEC in 1967 and was implemented by the member–nations in 1971. Also, the 6th Directive of 1977, as modified by the 9th Directive of 1978, aims at the improvement and simplification of the VAT throughout the Community.

Greece, being at the front doors of entrance in the EEC, started contemplating the implementation of the VAT and the harmonization of her tax system to that of the EEC, as Articles 95-99 of the initial Agreement of Rome provide. With this adjustment, taxes upon imported and domestic commodities would be the same.

Moreover, vertical monopolization, which was encouraged by the previous turnover taxes, and movement of capital and companies in countries with low taxes, would be avoided. There are considerable delays, though, in the harmonization process of special consumption taxes on certain products, especially wine, despite the fact that considerable progress has been made in introducing common taxes on manufactured tobacco, mineral oil, alcohol, and beer.

However, the member-nations, and eventually Greece, would be permitted enough flexibility to apply their own policies on matters of incentives for investment and income taxes to stimulate productivity and reduce inflation. Particularly for Greece, there is enough time for a thorough review and proper application of the value added tax and other reforms which are badly needed, independently of EEC membership. Such reforms would reduce bureaucracy, which is paramount in Greece, and increase the productivity of the public sector. Moreover, there would be less confussion over tax legislation, which the mass production of laws and regulations has created in the already over-saturated legal profession, especially in Athens (where there are 13,000 active lawyers compared to 4,000 in Paris).

Such a modification and simplification of the tax system would also help small and medium enterprises, since the disadvantages of the present turnover taxes, which favor vertical integration, would be eliminated. Instead, the horizon would be clearer for them to adjust their size in such a way that they can enjoy the best results from the viewpoint of economies of scale and factor productivity, preserving at the same time their independence.

Empirical Results

Despite the general impression that the public sector in Greece is relatively large, a comparison of the total tax revenues, as percentages of national income, with the EEC countries proves the opposite. As Diagram 1 indicates, general government receipts in Greece are less than 30 percent of the national income, compared with about 45 percent in the four large EEC countries. Lower direct taxes (mainly income taxes and social security contributions) in Greece are responsible for this difference as Diagram 2 demonstrates. On the other hand, indirect taxes (mainly turnover or sales taxes, stamp duties, and tariffs), as percentages of national income, are about the same in Greece as in the EEC countries, as Diagram 3 shows. Almost the same results can be found by comparing the ratios of central government taxes (direct and indirect) to national income. Moreover, there are no great differences in the expenditures on public administration, in which defense, public education, and health are included. They vary from 8 percent of the GDP for Greece to 10 percent for France, 11 percent for Germany and Italy, and 13 percent for the United Kingdom.

As percentages of total government revenue, direct taxes in Greece are far less than those in the EEC countries, while indirect taxes are higher in Greece, as Table 1 demonstrates. The ratio of direct to indirect taxes was 25.1 percent in 1960 and

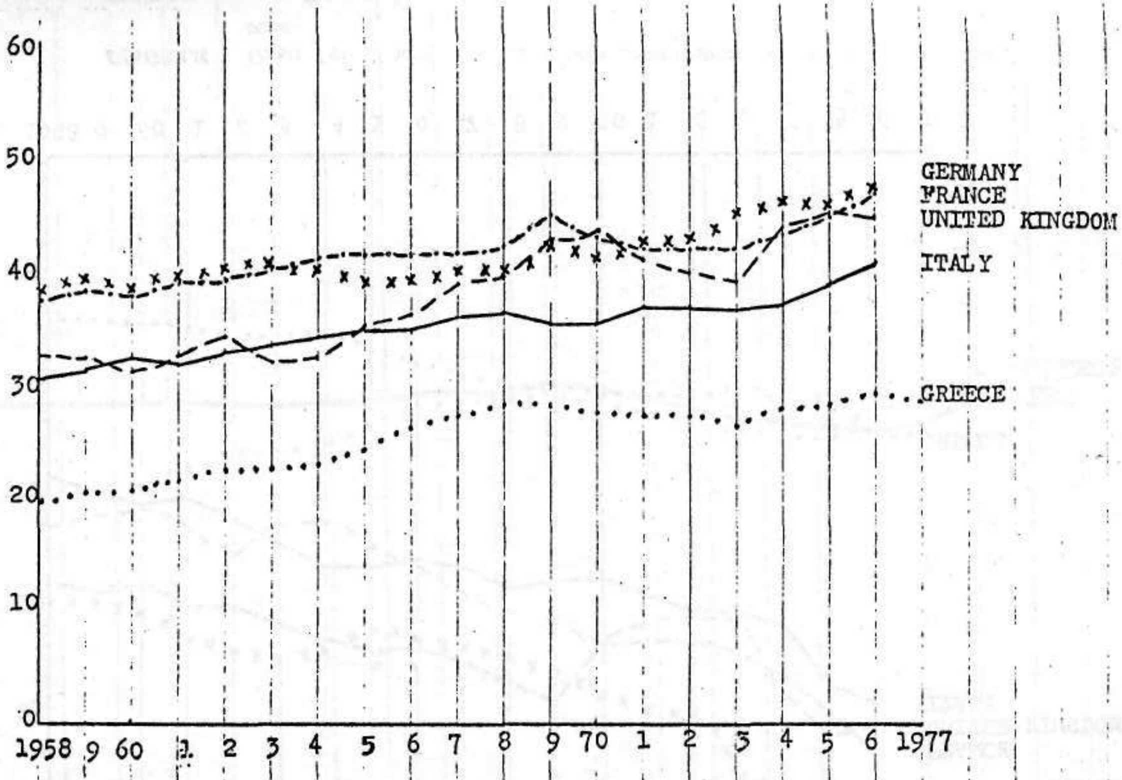

DIAGRAM 1. Total Receipts of General Government as Percentages of National Income (current prices).

SOURCE. Calculations were based on: OECD, *National Accounts*, various issues; and United Nations, *Yearbook of National Accounts Statistics*, various issues; Greek Government, Ministry of Coordination, *National Accounts for 1977* (provisional), Athens, 1978.

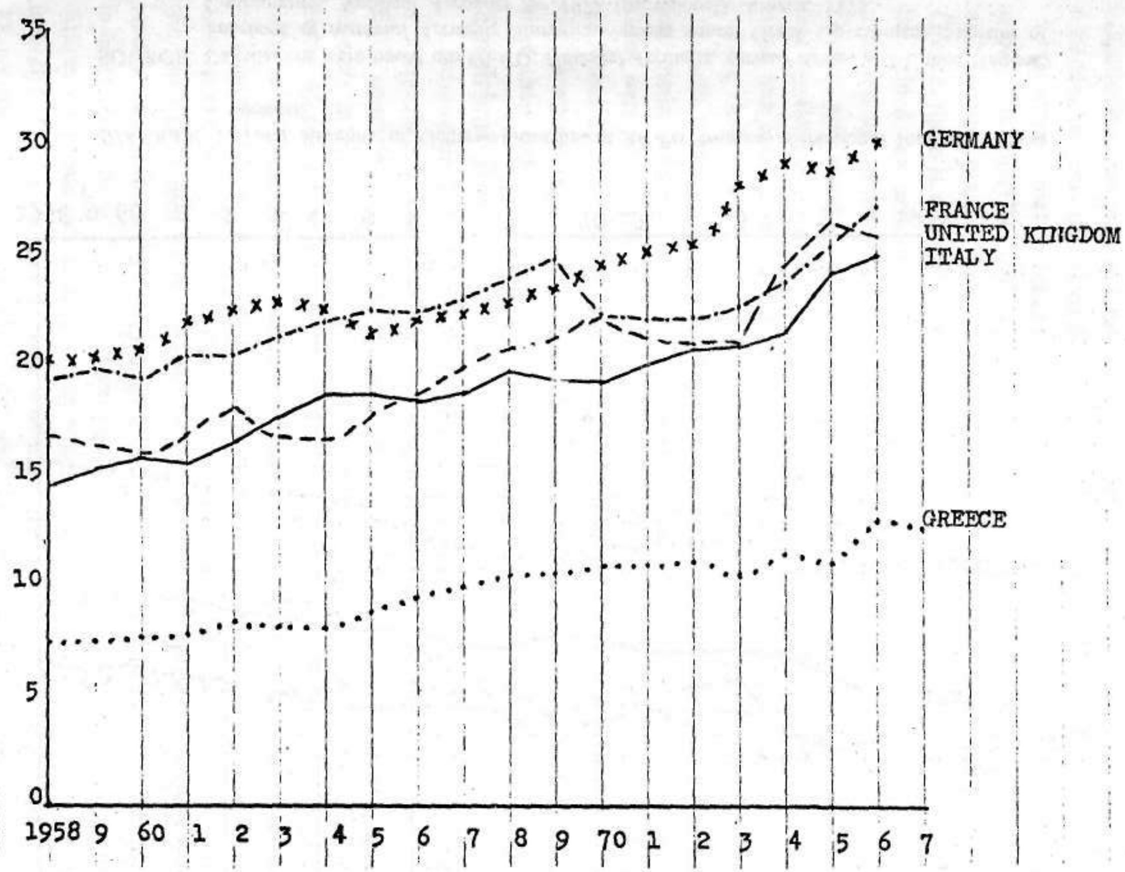

DIAGRAM 2. Direct Taxes (including social security constributions) as Percentages of National Income.

SOURCE. Same as Diagram 1.

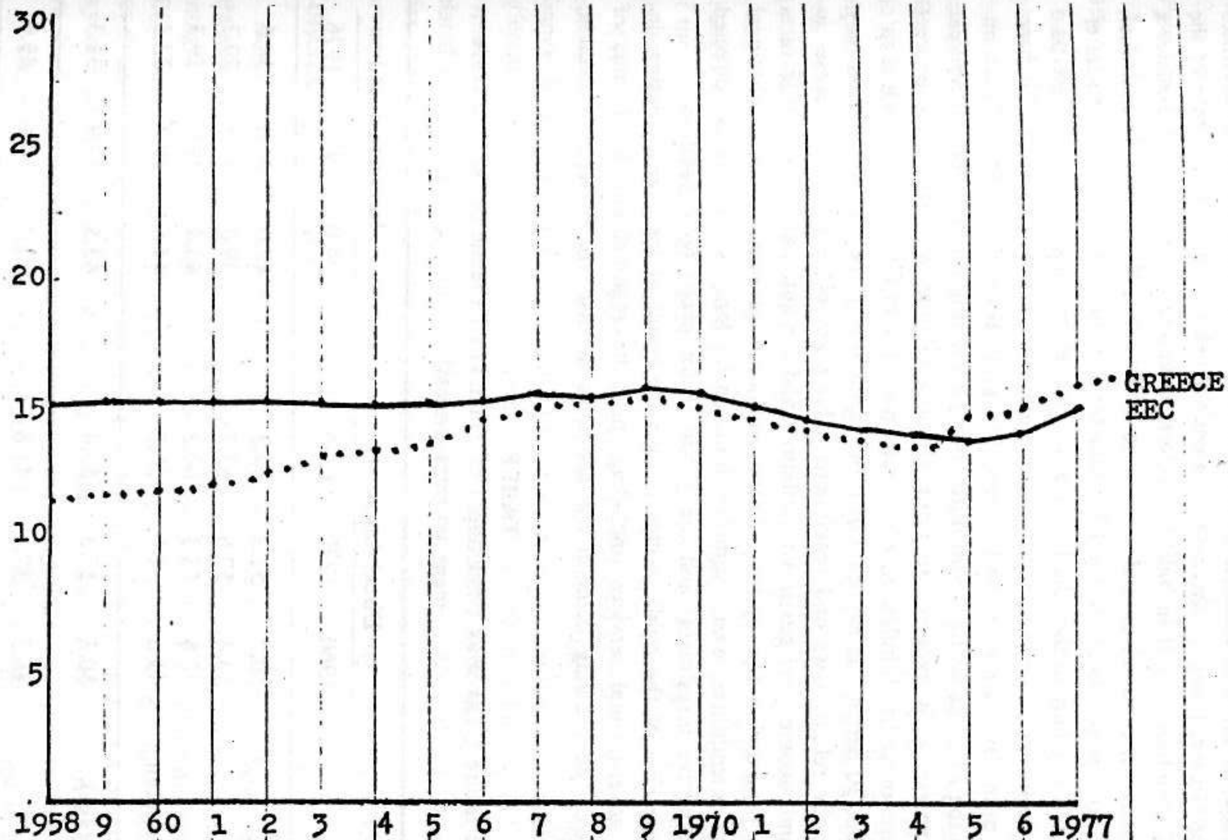

DIAGRAM 3. Indirect Taxes as Percentages of National Income: Greece and the EEC (average of France, Germany, Italy, and the United Kingdom).

SOURCE. Same as Diagram 1.

35.4 percent in 1976 for Greece, compared to an average of 57.8 and 90.1 percent, respectively, for the four large EEC countries. The same results can more or less, be found for the other small EEC countries, except Ireland which has about the same ratios as Greece. This indicates that as the per capita income increases, the ratio of direct ot indirect taxes also increases. This has been proven for many other countries as well. For Greece, however, this ratio remains far below that of the average of the above EEC countries (less than half). Therefore, Greek tax policy should consider a relative increase in direct taxes and a decrease or no increase in indirect taxes. Such a policy of tax harmonization to the EEC standards, would either have beneficial effects or would not hurt further the low income classes, because direct taxes are paid mainly by profiteers and people with high income, while the main burden of indirect taxes falls primarily on low income people. The gradual reduction of tariffs on imports from the EEC, as well as from third countries, during the transitional five-year period of accession, is expected to bring about a relative decrease in the indirect taxes. On the other hand, inflation, which runs presently in Greece at an annual rate of more than 20 percent, is expected to provide additional tax revenues without any changes in the related laws and regulations. This takes place through increases in spending and income, *pari passu* with inflation, and the automatic increases in rates under the progressive tax system. These additional revenues finance additional government expenditures, which stimulate inflation (as long as they are not directed toward productive investment) and the public sector keeps on expanding.

The expansion of the public sector is also the result of the ever-increasing demand for governmental services (including those by regional and local units of government). The growing demand for adequate defense and internal protection,

TABLE 1

Direct and Indirect Taxes as Percentages of Total Tax Revenue of General Government (current prices)*.

	Direct taxes			Indirect taxes		
	1960	1970	1976	1960	1970	1976
France	50.7	51.2	57.3	47.0	39.0	34.6
Germany	53.4	57.6	63.3	39.0	34.3	29.2
Italy	47.6	53.3	60.2	43.4	39.0	29.3
United Kingdom	49.6	51.2	56.7	44.6	39.2	32.3
EEC (average)	50.3	53.3	59.4	43.5	37.9	31.3
Greece	36.3	37.6	41.8	57.3	54.1	49.9

*: Social security contributions are included in direct taxes.
Source: Same as Diagram 1.

social security, health, education, and subsidization of certain sectors looms significantly in government disbursement and brings about a positive elasticity of income and public services. (For data supporting such elasticity, see S. Kuznets "The Share and Structure of Consumption", *Economic Development and Culture Change,* Vol. 10, no. 2, Jan. 1962; and N. Gianaris, *Economic Development: Thought and Problems* (North Quincy, Massachusetts: The Christopher Publishing House, 1978), pp. 228-32. To finance the required expenditures for all these services, higher taxes are needed.

A regression analysis of indirect taxes on private consumption for the twenty years 1958-1977 was used to determine the slope and its reliability for the Greek economy. The slope, 0.23, means that, on the average, an increase of private consumption by 100 drachmas is related to an increase of government revenue from indirect taxes by 23 drachmas. Imports, though, are more important in explaining indirect taxes. The regression of indirect taxes on imports shows a slope, 0,54, which is higher than the previous one on private consumption. This means that an increase of imports by 100 drachmas is associated with an increase in indirect taxes by 54 drachmas. On the other hand, inflation, measured by the ratio of GDP at current prices over the GDP at constant 1975 prices, explains about 14 percent of the changes in indirect taxes, while changes in total national income, explain 16 percent of the changes in indirect taxes. The fit in all regression lines was very good. The adjusted coefficient of determination, $\overline{R}^2$, was more than 0.974 in all cases.

Ceteris paribus, these reliable regression lines can be extrapolated for future projections on matters of taxation and related public policies. Governmental measures to change the tax structure, as a result of Greece's accession to the EEC, might lead to different relationships of indirect taxes to national income, or inflation, and, especially, imports. However, such extrapolated lines could still be used as the basis of related policies, although modifications would be needed. Also, the 4 largest countries of the EEC had about the same percentage of indirect taxes to national income (around 15 percent), which was amazingly constant during the years 1958-77.

Concluding Remarks

Despite of criticisms that the public sector in Greece is relatively large, statistical data support the opposite. Total governmetntal spending as well as taxation, as percentages of national income, are far less in Greece (about 30 percent) than in the EEC countries (close to 50 percent). Such criticisms of the public sector, which prevail also in many Western countries (including the EEC and the United States), may be justified on grounds of growing bureaucracy and extensive controls, which in turn lead to inefficiency and low productivity in this sector.

It seems that deep structural changes and reforms are badly needed in both the Greek public and private sectors to help raise productivity and quality of services.

Such structural changes should de-emphasize the over-swollen tertiary sector and encourage the more productive secondary and primary sectors.

The present unusual and, to some extent, artificial character of the Greek economy, where there are fewer gainfully employed, and more income-collecting persons, results mainly from: a) economic instability, b) the extensive emigration of workers and c) the underdeveloped nature of the country's economy in the previous decades. However, based on the over-all performance of the economy in the post-war years, one can expect that the country will be able to achieve most of the needed structural changes. The fact that this problem is generally recognized by both critics and non-critics of the public policy, supports this optimistic expectation.

With structural changes in the public sector and the economy as a whole (as a result of Greece's accession to the EEC) there would be more stability in the economy, a better response to the signals of the market (through the price mechanism), a more efficient allocation of resources, and less inflationary pressures. More decisions would be taken on the sectoral or entrepreneurial, and not necessarily ministerial, level, and bureaucracy as well as unnecessary public spending would probably be reduced. In the meantime, the Greek government should try to implement needed policies of regional development similar to those in northwestern France and southern Italy, where loans are provided with low or no interest, taxes are waived for a number of years, and generous subsidies are offered to expanding or new enterprises, creating jobs in these less developed regions.

Tax harmonization with the EEC would mean a relative increase in the direct taxes of Greece, as well as structural changes in both, direct and indirect taxes. A major tax reform which is contemplated presently in Greece, is the introduction of the value added tax. This tax, which is being considered for adoption in the United States as well, would replace the present turnover and other complicated indirect taxes. As a result, small, non-vertically concentrated enterprises, which are the large majority in Greece, would be in a relatively better competitive position. They are the ones upon which the great pressure of EEC competition would fall and need all the support they can get.

Here, public finance and credit policy are expected to play significant roles in programming and supporting the proper allocation of investment to the most promising sectors and industries. The relatively cheap labor in Greece and the expected confidence for long term investment, after the accession to the EEC are two encouraging factors for future enterprises. From that point of view, the public sector could support entrepreneurial and technical training and even venture in, together with the private sector, the establishment of new industries, or encourage cooperation and merger of small, low-efficiency firms, so that they could be able to survive competition from larger EEC enterprises.

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