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AUSTRALIA

ECONOMIC STRATEGY

Notes from the Field

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Why the Eurogroup is Wrong

The Eurogroup is setting a budget surplus target for Greece that is 2.5 times the rate now being achieved by Germany.

The Eurogroup is the council of finance ministers of the Euro Area. It has been negotiating with Greece on extension of the Greek bailout package. The breakdown of these negotiations is the cause of the current Greek crisis and the aggressive sell-off in international equity markets.

At the time of writing, Greece has been forced to close its banks and subject its citizens to capital controls. For ordinary Greeks, this means that they can withdraw no more than 60 euros per day from their bank ATMs. Greek corporations can do international transactions in euros but only with the prior approval of the Greek government.

The Eurogroup, in a statement on 28 June, published the latest proposals agreed among the three institutions (European Commission, European Central Bank and the International Monetary Fund) as they were when negotiations broke down on 27 June 2015. Jean-Claude Juncker, the President of the European Commission, has described Greece's non acceptance of these proposals as a “betrayal”.

The Eurogroup Proposals

In the circumstances we thought we may actually look at these documents as they were released. There are many components.

Value Added Tax Reform

It is proposed to unify the value added tax rates (GST rates to Australians) at a standard rate of 23%, which includes restaurant and catering and a reduced 13% rate for basic food, energy, hotels and water (excluding sewerage). There is a super reduced rate of 6% for pharmaceuticals, books and theatre. The Eurogroup no doubt regards these reductions as major concessions.

Fiscal Structural Measurements

It is proposed to take measures to increase the corporate income tax rate in 2015 and require 100% advanced payments for corporate income as well as individual business income tax by the end of 2016. This is similar to Australian provisional tax requirements. It is also proposed to eliminate the preferential tax treatment of farmers in the income tax code, eg. subsidies on the diesel fuel excise for farmers will be abolished.

Pension Reform

Effective from 1 July 2015, the authorities will phase in reforms that will deliver estimated permanent savings of 1% of GDP on a full-year basis in 2016 and thereafter. It is proposed to raise the statutory retirement age to 67 years (or 62 years and 40 years of contributions) by 2022. This is applicable for all those retiring except arduous professions and mothers with children with disabilities.

There are many further proposals in other areas of government.

What the Eurogroup did not do

The Eurogroup has entirely missed the point. The fact that it has missed the point is immediately evident when we look at the first paragraph of its release of 28 June. The Eurogroup continued to insist that Greece reach a primary budget surplus of 3.5% of GDP by 2018.

We have previously noted that it is the opinion of most economists who are specialists in this area that this budget surplus target is unsustainable. We have previously noted that such a primary budget surplus has been been achieved only once in the history of the Euro Area. This was by Finland during the period of the Nokia boom. Finland is today running a budget deficit and it could not repeat this previous performance.

The largest and most powerful economy in the Euro Area is Germany. This year Germany should record a primary budget surplus of 1.4% of GDP. This is the highest budget surplus that Germany is expected to achieve this decade. The Eurogroup is expecting Greece with one of the weakest economies in Europe to run a surplus which is 2.5 times the surplus that is currently being run by the strongest economy in Europe. It is generous to describe this target as unrealistic. Again, most economists of high standing in this area of economics merely refer to this target as unsustainable.

A realistic solution to this crisis would require forgiveness of official Greek debt by the Eurogroup. Greece needs to reduce the level of its sovereign debt from just under 180% of GDP now to no more than 90% of GDP. Were this achieved, then Greece could achieve a sustainable primary budget surplus of around 1.5% of GDP or around what Germany is currently doing. Until the restructuring of Greek sovereign debt is achieved, no solution to the Greek situation would appear to be sustainable.

Conclusion

The Eurogroup is wrong. The terms it is offering to Greece is that Greece should run a primary budget surplus which is 2.5 times the rate that is currently being run by Germany.
The current public position of the Eurogroup is that this is a reasonable proposal. In taking this position the Eurogroup may indeed delude some of the market. The more dangerous possibility is that the Eurogroup also deludes itself.

References:

Information from the European Commission on the latest draft proposal in the context of negotiations with Greece: European Commission – Press Release, Brussels, 28 June 2015

2015 supplementary budget and 2016-19 MTFS – Actions to be taken in consultation with EC/ECB/IMF staff: 26 June 2015 - European Commission – Press Release, Brussels, 28 June 2015

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