

Debt, Austerity or Fiscal Trap: Lessons from the Greek Case

Titos Ritsatos¹

Abstract

Greece has experienced an unforeseen reversal of fortune during the last five years. Since 2009, Greek sovereign debt has mounted high enough to be considered non-serviceable. Using recent experience from the Greek sovereign debt crisis, an ex-post evaluation of adopted policy effectiveness is pursued. Greece, lacking institutional depth protecting its own interests, was unable to deploy the appropriate strategy and preserve interests with concrete tactics at critical points. The result is an effective debt trap in which the effort to escape through austerity has only reinforced the enclave.

Keywords: Fiscal policy, sovereign debt

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During the last five years, Greece has experienced an unforeseen reversal of fortune, turning from high economic achievements to one of the greatest modern economic tragedies. The evolution of the Greek economy along with the policies applied presents a notable case for study.

While sustaining a steady growth during the 1990's, Greece was awarded the 2004 Olympic Games in 1999, was accepted in the EMU in 2000 and adopted the Euro on January 1st, 2002.

¹College of Mount Saint Vincent, 6301 Riverdale Ave, Bronx, NY 10471, United States.
Email: titos.ritatos@mountsaintvincent.edu. Phone: (718) 405-3375.

For the period of 2002 - 2007, Greek public debt while increasing in nominal amounts was kept almost constant as a percentage of GDP (around 100%), mainly due to strong domestic GDP growth. During the same period, debt service cost decreased significantly, due to the decrease in effective bond yields. Greek bond spreads over German bond yields were contained within thirty (30) basis points. The manageability of Greek debt deteriorated drastically in 2008 and 2009, when debt grew to 113% and 130% of GDP respectively. The global financial crisis had dual negative economic impacts on Greece. First, it increased the debt level in order to support the domestic banking system, and it also increased debt servicing costs, due to consecutive downgrades and the flight of capital to quality investment destinations. Due to mounting debt service pressures, on April 23, 2010 the Greek government called for a joint Eurozone – IMF rescue plan, inaugurating the Greek sovereign debt crisis.

This paper investigates the effectiveness of fiscal policy measures adopted from the beginning of the Greek crisis until recently.

Fiscal Policy, during the Greek Sovereign Debt Crisis

Responding to the governmental request, on May 2nd 2010, Eurozone finance ministers agreed to “rescue” Greece providing a one hundred ten billion euro (€110 B) loan facility to be disbursed in tranches over the following three years. Funds were to be released under the condition of strict fiscal policy, targeting fiscal consolidation by eleven percentage points in order to comply with the EU Stability and Growth Pact. Fiscal policy was imposed in three consecutive austerity packages launched on February 9, April 23 and May 1st, 2010 respectively. Imposed measures included, between other moderate cuts in public sector wages and pensions, an increase in tax assessment basis for real estate taxes and four percentage points increase in value added tax (from 19% to 23%). Skeptics who had observed that the domestic economy was predominantly “government-fed”, predicting that austerity measures would reduce consumption and increase unemployment leading to further declines in GDP, were validated within a year. First, on November 15, 2010, Eurostat announced the budget deficit for 2009 to be 2% higher than originally expected at 15.6%. Subsequently, on April 16 2011, according to Paris & Talley (2011), IMF officials publicized their belief that Greece’s debt was unsustainable. Despite austerity, fiscal consolidation targets were not attained, since the budget deficit was still at 10.7% for 2010, while the agreed three–year consolidation plan seemed unrealistic.

Under pressure from lenders, Greek Parliament enacted a second set of austerity measures on June 29, 2011, in accordance with the "*Medium Term Fiscal Strategy 2012-2015*"². That second set included, between other, effective increases in personal income taxes through change in income tax brackets and elimination of deductions, introduction of per capita excise tax and increase of various types of indirect taxes (sin taxes), while cutting further wages and expenses in the government sector. Furthermore, in order to increase labor productivity, measures were extended to the private sector (minimum wage for new entrants in the labor force decreased 20%, and the maximum length of finite-time employment contracts increased to three years). As stated by Davlos (2011) on August 20th, tax revenues were drastically lower than expected despite all measures taken. In an effort to increase tax revenues, a new austerity package was introduced on October 6th 2011, imposing further cuts in public sector salaries and pensions. Creative and controversial novelties were introduced, such as the new real estate tax collected through the electricity bill.

Despite the series of measures introduced in 2010 and 2011, the sought after fiscal consolidation plan still seemed to be unrealistic, mainly due to the persistence of budget deficit. At the end of 2011, tax revenues were decreasing; total debt had soared to €355 Billion or 170% of GDP, while the main contributing factor, the budget deficit, was still close to 10% of GDP. Austerity proved ineffective and inadequate to provide the appropriate solution to the fiscal and economic problems of Greece.

Debt restructure and the Debt Trap

As various IMF officials had commented before, non-serviceable Greek debt needed a "*haircut*". On February 21, 2012, the Greek government, EC and IMF called for a 53.5% "*haircut*" in the nominal face value of Greek debt held by private investors. The debts restructure agreement included write-offs of approximately €100 Billion³, while necessitating new loans of €30 Billion in order to recapitalize participating domestic Banks. The net effect of approximately €50 Billion in debt reduction accomplished in 2012, included financing of current budget deficit.

² Medium Term Fiscal Strategy 2012-2015. Retrieved from <http://www.minfin.gr/content-api/f/binaryChannel/minfin/.../MTFS.pdf>

³ Half of total write-offs are estimated to be held by Greek financial institutions and individual investors.

Table 1: Key Economic Indicators

| Current Billion € | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|--|-------|-------|-------|-------|------|-------|-------|------|-------|
| GDP | 185 | 193 | 209 | 223 | 233 | 231 | 222 | 209 | 194 |
| TAX REVENUE | 70.5 | 75.3 | 81.9 | 91.0 | 94.7 | 88.5 | 90.1 | 88.6 | 86.7 |
| AS % OF GDP | 38% | 39% | 39% | 41% | 41% | 38% | 41% | 42% | 45% |
| TOTAL DEBT | 183.2 | 212.3 | 224.7 | 239.9 | 263 | 299 | 329 | 355 | 305 |
| AS % OF GDP | 99% | 110% | 108% | 108% | 113% | 130% | 148% | 170% | 157% |
| BUDGET DEFICIT % of GDP | 7.5% | 5.2% | 5.7% | 6.5% | 9.8% | 15.6% | 10.7% | 9.5% | 10.0% |

As seen on table 1 above, notwithstanding a significant (15%) reduction, debt was still over 150% of GDP; unemployment was increasing while GDP was decreasing with the effect on budget deficit still being ambiguous. With continuous pressure for effective fiscal consolidation, the Greek government introduced in late February a third austerity plan targeting a €3.3 Billion (1.7%) reduction in budget deficit. Pledging permanent spending cuts including lower pension payments and a twenty percent reduction (20%) in the minimum wage, restoration of lost productivity was attempted.

However, despite all relevant austerity measures imposed, the budget deficit for 2012 increased marginally at the 10% benchmark, while by the end of 2012 unemployment had risen to 26.1% and real GDP had decreased by 6.4%. What had eventually been accomplished after three full years of austerity, a couple of "celebrated" bailout plans and a "successful" debt restructuring? Since financial transactions constitute a "zero sum game", accomplishments should be sought on both sides of the transaction.

On the side of the debtor, at least one out of four real jobs and one fifth of real GDP have been lost since 2009. On the fiscal front, tax revenues decreased and total debt started to accumulate again, mounting at 157% of GDP.

Funds derived from debt restructuring were directed to the financing of continuing budget deficits, leaving at the end of 2012 a higher nominal debt compared to that of 2009, while the economy had contracted more than 20% in real terms, increasing the effective debt to GDP ratio. Fiscal consolidation seems to be unattainable with fiscal-only policy measures. As Darvas (2012) suggests, Greece has entered a debt trap without obvious escape. When entrenched in an effective debt trap, distorted incentives may promote acceptance of long-term debt obligations under conditions that strongly favor the lender.

Austerity, Fiscal Trap and the Possibility of Default

Austerity decreased real GDP, reducing tax bases on both personal and corporate income tax levels. Indirect taxation increased consumer prices reducing consumption and tax collections. Reduced consumption eliminated profits of firms in competitive markets, creating a wave of business closings reinforcing a spiraling effect with increased unemployment and further decreases in consumer spending. The spiraling downward effect constitutes a fiscal trap as described by Hanssgen and Papadimitriou (2012).

As seen in table 2 and table 3 below, effective income tax rate increased drastically (at least 29%) in lower income brackets (income less than €26,000), while VAT tax increased 21% for the "regular" goods and 44% for the "essentials".

Table 2: Taxation Increase per Income Bracket

| in € | 2009 | | 2012 | | 2010-2014 | | 2009-2012 |
|---------|--------|--------------------|--------|--------------------|-----------------------|--------------------|--------------------|
| Income | Tax | Effective Tax Rate | Tax | Effective Tax Rate | Additional Excise Tax | Effective Tax Rate | Eff. Rate Increase |
| 5,000 | 0 | 0% | 0 | 0% | 0 | 0% | 0% |
| 12,000 | 0 | 0% | 700 | 6% | 0 | 0% | 999% |
| 16,000 | 720 | 5% | 1,420 | 9% | 40 | 0% | 103% |
| 26,000 | 3,200 | 12% | 3,920 | 15% | 200 | 1% | 29% |
| 40,000 | 8,000 | 20% | 8,820 | 22% | 480 | 1% | 16% |
| 60,000 | 15,600 | 26% | 16,420 | 27% | 980 | 2% | 12% |
| 100,000 | 31,600 | 32% | 32,420 | 32% | 2,180 | 2% | 9% |

Table 3: Change in VAT tax per product category

| | HIGH | REGULAR | LOW | SUBSIDIZED |
|---------------------------|-------------|----------------|------------|-------------------|
| 1987-1992 | 36% | 18% | 8% | 4% |
| 1992-03/2005 | | 18% | 8% | 4% |
| 04/2005-03/2010 | | 19% | 9% | 4.5% |
| 04/2010-06/2010 | | 21% | 10% | 5% |
| 07/2010-12/2010 | | 23% | 11% | 5.5% |
| 2011 | | 23% | 13% | 6.5% |
| % Change 2010-2011 | | 21% | 44% | 44% |

Furthermore, increasing tax rates, even though proven inadequate to provide increased tax revenues, actually resulted in raising significantly the percentage of tax revenues in GDP. As seen in Table 1, €86.7 Billion of total tax revenues in 2012 counted for 45% of GDP, while 90.1 Billion in 2010 were only 41% of GDP. Increased tax rates produced lower tax revenues, a clear Laffer (2004) effect resulting from an effective austerity trap forced by lenders' interests.

More important for the domestic market though was the vertical increase of unemployment, as seen in table 4 below:

Table 4: Unemployment Rate by Month 2010-2013

| Unemployment % by Month | 2010 | 2011 | 2012 | 2013 |
|----------------------------|------|------|------|------|
| JANUARY | 11.3 | 15.1 | 21.5 | 26.4 |
| FEBRUARY | 12.1 | 15.9 | 21.7 | 26.6 |
| MARCH | 11.6 | 16.2 | 22.1 | 26.8 |
| APRIL | 11.9 | 15.8 | 23.1 | 27.2 |
| MAY | 12.0 | 16.6 | 23.9 | 27.5 |
| JUNE | 11.6 | 16.0 | 24.7 | 27.5 |
| JULY | 12.0 | 16.5 | 25.0 | 27.6 |
| AUGUST | 12.2 | 18.4 | 25.4 | 27.5 |
| SEPTEMBER | 12.6 | 17.5 | 26.0 | 27.7 |
| OCTOBER | 13.5 | 18.2 | 26.0 | 27.8 |
| NOVEMBER | 13.9 | 20.9 | 26.2 | 28.0 |
| DECEMBER | 14.8 | 21.0 | 26.1 | |

The tools of government intervention vary across the European Union with own currency being the largest difference. When Greece was unable (or unwilling) to comply with the EU Stability and Growth Pact, it had already given up its ability to self-correct through currency devaluation or monetary policy measures. The only available policy, other than default, was fiscal consolidation backed by an EU-led bailout. Overall, the borrower as a whole has given up approximately one fourth of its accumulated capacity measured by GDP, without being able to reduce the effective debt burden as measured by the debt-to-GDP ratio.

Was actually default an option? It definitely was, but never considered. The administration was adamant on seeking a bailout plan, stretching the negative possible outcomes of default and exiting Eurozone. Proponents of default argued on the increased bargaining power of the borrower, threatening the possibility of a contagion effect. While it is unfair to criticize economic policy makers from the safety of the library, it is fair to seek ex-post respective profits or losses from the "*zero sum game*" of sovereign debt.

Holders of Greek sovereign debt have changed drastically since the first bailout program. As analyzed by Zettlemeyer, Trebesh and Gulati(2013), the majority of Greek debt in 2009 was held by private institutions and investors. The pre-PSI debt restructurings bailed out lenders by either providing payment or collateralizing obligations to approximately 37% of unsecured bondholders. After the completion of PSI, approximately 80% of Greek sovereign debt is placed with EFSF, ECB/Eurozone Central Banks and IMF. According to Karavias and Monokroussos (2012), the average annual interest rate charged on the "*reconstructed*" Greek sovereign debt amounted to 2.78% (a percentage judged high enough for a friendly bailout between partners). PSI participants, while forced to realize part of their "*mark to market*" paper losses, received superior quality notes in exchange. Concentration of debt holdings in a concrete and uniform group drastically shifted the balance of bargaining power towards the side of lenders. Overall, initial restructurings and PSI protected the interests of non-Greek financial institutions, collateralizing obligations and minimizing potential losses.

Conclusions

Despite the efforts of Greek government along with its European and International partners, Greek sovereign debt seems to be non-serviceable in its current structure. Debt restructuring programs and their accompanying measures have resulted in a significant loss of domestic productive capacity, while securing Lender's interests. As shown in table 5 below, between 2008 and 2012 the Debt-to-GDP ratio has grown 58.1%, while nominal tax revenue has decreased 8.5% and 21.7% of real GDP has been lost.

Table 5: Table of Changes in Debt, GDP and Tax Revenue

| % CHANGE BETWEEN 2008 and 2012 | | |
|--------------------------------|-----------------------|--------------------|
| DEBT / GDP ratio | Change in Tax Revenue | Change in Real GDP |
| 58.1% | -8.5% | -21.7% |

Greece should have defaulted and exited the Eurozone in 2009. Even better, Greece should have not adopted the common currency in 2002, applying the principles of financial risk management to the management of its own debt. On the other hand, applying the principles of Lender Liability, leading EU members should not have let Greece enter the Eurozone, since they knew about Greek statistics. They also knew that during the past decades, capital inflows from the EU were directed to non-productive investments depriving the country of the appropriate infrastructure and the necessary productive capacity. Assuming that overconfidence and optimism led both sides to the wrong decision in late 1990's, the same does not hold for 2009.

An ex-post observation reveals that lenders (Eurozone financial institutions and their stakeholders) were well prepared for the upcoming default. On the other hand debtors (Greece), lacking formed institutional depth seeking and protecting own interests, were unable to deploy the appropriate strategy and preserve interests with concrete tactics at critical points. The result is an effective debt trap in which the effort to escape through austerity has reinforced the enclave. Besides "*deus ex machina*", only lenders can provide a solution even in a "*game-theoretical*" approach. If lenders, for their own sake, decide to make debt manageable, they should still curtail fiscal sovereignty of debtors, until appropriate institutional depth is either formed, adopted or imposed.

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