The contribution of tax policy to growth

Description

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Despite the headwinds caused by the major turmoil and rapid changes in the international environment, Greece's macroeconomic outlook for 2025 remains more positive than that of the euro area, mainly for circumstantial reasons. The European Commission's winter forecasts confirmed the resilience of the Greek economy, estimating growth of 2.1%-2.3% over the three-year period 2024-26, compared with just 0.8%-1.6% in the euro area. However, Greece has lost precious time due to the clientelism-based politics that led the country into bankruptcy and memoranda with official creditors, so the gap with the EU average income remains wide. With 2008 as the base year, Greece's per capita disposable income was 81.6% in 2023, compared with 111.1% in the EU. At the same time, debt remains the highest in the EU and is a source of uncertainty as maturing low-interest debt owed to European partners is refinanced with newly issued bonds sold to investors at market rates.

After the Recovery and Resilience Fund expires in 2026, growth is projected to decline to the potential rate of around 1%, which is determined by the fundamentals of the Greek economy, including a declining and ageing population. The main objective of economic policy should be, on the one hand, to increase the potential growth rate of the economy to accelerate convergence with the Euro area countries, and, on the other hand, to gradually reduce the debt to below 100% of GDP. The only way to raise growth in the medium term, despite adverse demographic trends, is through productivity-enhancing investments. The prerequisites are well known and include speeding up justice reform; increasing the efficiency of public administration; further simplifying investment licensing; completing the land registry and land use; improving education and its link to the labour market; and reducing taxes on production and income (not consumption), i.e. reducing direct rather than indirect taxes.

Starting with the latter, reducing taxes on production and income would help to close the investment gap created during the crisis years of 2010-18, which remains quite large. The increase in employment in recent years and the reduction in the burden on wage costs via lower social security contributions are helpful, but not sufficient. The “tax wedge”, i.e. the difference between the net wage received by the worker and the cost to the firm that employs him or her, remains high and acts as a disincentive to hiring. Despite gradual reductions, social security contributions remain high, and the tax scale is also highly progressive, with a top rate of 44% on incomes above €40,000, well below that of other EU countries. With a cumulative inflation of 17% over the last three years, the non-indexation of the tax brackets offsets the tax cuts implemented by the government, as higher incomes fall into higher tax brackets. KEFIM has proposed a flat tax, a proposal recently endorsed by the OECD. At the very least, the income threshold above which the maximum tax rate of 44% is applied should be doubled to €80,000 to reduce the progressivity of the current tax system, which makes it difficult to attract professionals and managers to our country and exacerbates the already acute problem of brain drain.

At the same time, the tax framework for depreciation could provide greater incentives for investment to help close the investment gap and raise investment as a share of GDP from the current 14% closer to the European average of 22%. Greece remains the only EU country that simultaneously (a) provides for a very limited period of 5 years during which losses can be offset against future profits (carry forward) and (b) strictly limits the possibility of adjusting tax depreciation to the useful life of the asset by setting the depreciation of industrial equipment at 10% per year for 10 years. The combination of these features particularly affects companies that systematically invest in digital equipment, which depreciates quickly, and those that invest in fixed assets with a long payback period, for which the 5-year carry forward is not sufficient. The carry forward period could be extended to 10 years and the option of accelerated depreciation to 5 years could be offered for fast-depreciating assets instead of the current 10-year linear depreciation. The benefits would be significant, including improved competitiveness and the ability to attract new investment, supporting the government's goal of increasing the share of manufacturing in the national economy from 10% to closer to the EU average of 15%, with a focus on technology and human resources with digital skills.

Businesses are calling for accelerated tax write-offs for new investments, but the government seems reluctant to proceed without the Commission's agreement not to count them as tax expenditure and thus not to include them in the annual public expenditure growth limit imposed by the new fiscal compact. To avoid protracted negotiations with the Commission with an uncertain outcome, we suggest that the government move immediately to accelerate the amortisation by cutting other expenditures. For example, it could decouple all social benefits, worth hundreds of millions, from increases in the minimum wage (which includes productivity growth) and instead index them to inflation. There is no reason why benefits should rise faster than inflation.

Clearly, tax policy alone is not enough to generate strong growth in a stable fiscal environment. An important challenge is to improve the functioning of the judiciary and the state apparatus. According to the World Justice Project report, Greece ranks 47th out of 142 countries and 29th out of 31 developed countries (EU, EFTA and US) in 2024 on the rule of law index. Greece's ranking is the same as in 2023, and there is no apparent trend of improvement since the survey was launched in 2015. In the public sector, political party appointments to vacant positions in the state apparatus must be stopped once and for all, and true meritocracy must be applied. The system of targeting, evaluation and bonuses for supervisors, established in the public sector by Law 4940/2022 and gradually implemented, is a first step. It covers some 250,000 employees in the broader public sector, excluding teachers, judges, nurses, doctors, police and military personnel. Without further improvements in transparency, evaluation and target-setting across the public sector, attracting investment and raising productivity will be challenging.

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