

### **Greece: Selected Issues**

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INTERNATIONAL MONETARY FUND

GREECE

**Selected Issues**

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Approved by the European Department

March 27, 2008

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## I. COMPETITIVENESS AND SAVING-INVESTMENT BALANCE: AN UPDATE<sup>1</sup>

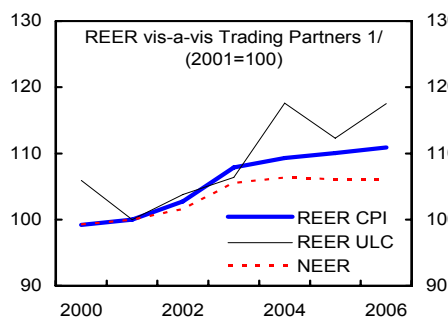
### A. Introduction

1. **The assessment of Greece's competitiveness remains broadly unchanged from that discussed in *Greece: Selected Issues* (IMF Country Report No. 07/26).** Greece continues to face a large competitiveness gap which has been accompanied by a marked deterioration in the external current account balance. In view of Greece's membership in the EMU, the availability of financing for the external deficit is not a concern, but rising indebtedness could weigh appreciably on growth going forward. National accounts data suggest that declining household saving and increasing housing investment have been the key factors underpinning the recent increase in the saving-investment gap. Going forward, important considerations are to what extent the decline in household saving is a temporary phenomenon and whether the profitability of the corporate sector will remain robust despite growing competitive pressures.

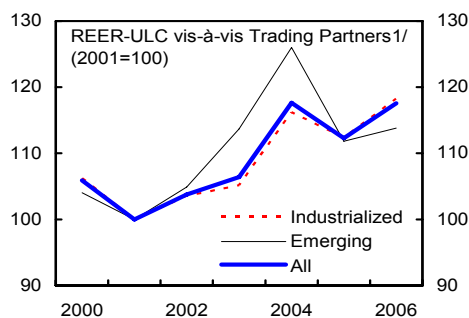
### B. Measures of Competitiveness

2. **Standard indicators point to a steady deterioration in competitiveness vis-à-vis trading partners.** Since EMU accession in 2001, Greece's CPI-based and ULC-based real effective exchange rates have appreciated by 10 percent and 17 percent, respectively. The appreciation

has been more pronounced vis-à-vis emerging markets. However, this divergence vis-à-vis emerging



Source: IMF, *International Financial Statistics*; OECD; and IMF staff calculations.  
1/ INS weights. ULC of manufacturing.



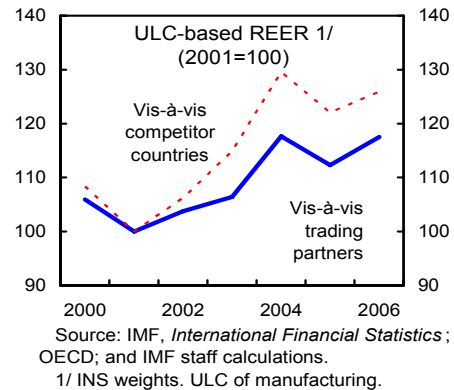
Source: IMF, *International Financial Statistics*; OECD; and IMF staff calculations.  
1/ INS weights. ULC of manufacturing.

markets and industrialized countries has narrowed in the past few years.

3. **An alternative indicator of competition from third-market competitors also shows extensive loss in Greece's competitiveness.** This indicator is derived by using the

<sup>1</sup> Prepared by Keiko Honjo.

share of Greece's main export categories in its total exports as the weights vis-à-vis the world's largest exporters of these product categories. With substantially larger weights given to emerging markets economies, especially those in Asia which are not included among Greece's trading partners, this alternative indicator shows a cumulative appreciation of nearly 30 percent since 2001, about 10 percentage points higher than the standard measures of competitiveness based on trading partners. In addition, estimates based on the CGER methodologies suggest a competitiveness gap in the range of 30 to 40 percent.<sup>2</sup>



Main Countries Included in REER Calculations and Weights

Trading Partners		Competitor Partners		Top 10 Export Categories (Average 2000–06)	
				SITC Rev. 3	Percent of total exports
Industrialized countries	84.2	Industrialized countries	59.2	Total	91.8
<i>Of which:</i>		<i>Of which:</i>		<i>Of which: Top 10</i>	
Germany	18.6	Germany	10.3	84 Apparel/clothing/access	12.9
Italy	15.7	United States	9.3	05 Vegetables and fruit	9.5
United Kingdom	8.8	Japan	5.7	68 Non-ferrous metals	7.3
France	8.7	Italy	5.1	54 Pharmaceutical products	4.8
United States	7.3	France	4.9	65 Textile yarn, fabrics,art.	4.5
Emerging markets	15.8	Emerging markets	40.8	77 Electrical equipment	3.9
<i>Of which:</i>		<i>Of which:</i>		67 Iron and steel	3.7
Korea	3.9	China	13.0	12 Tobacco/manufactures	3.5
Cyprus	2.7	Hong Kong, SAR	5.3	89 Miscellaneous manuf.	3.2
Turkey	1.9	Korea	3.3	66 Non-metallic mineral manuf.	2.8
Bulgaria	1.8	Mexico	2.6		
Romania	1.4	Singapore	2.5		
Total	100.0	Total	100.0	Sub-total	56.1

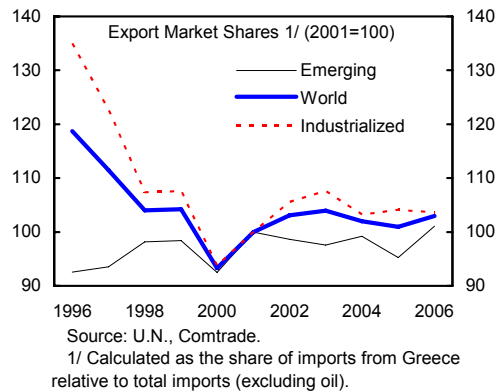
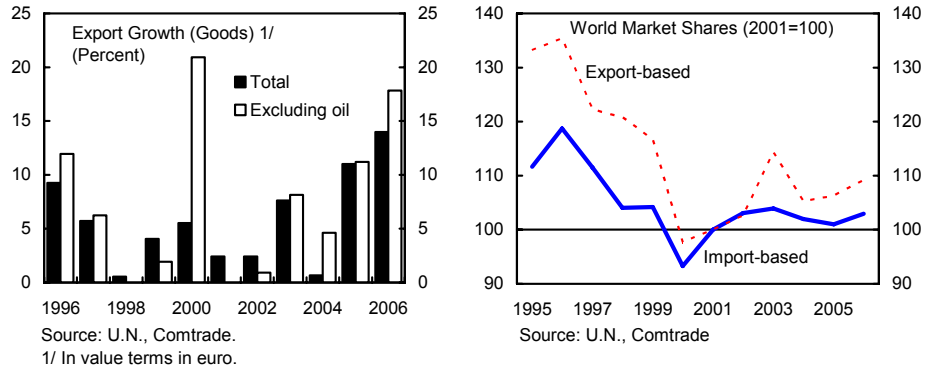
Sources: U.N., Comtrade; IMF, *Information Notice System*; and IMF staff calculations.

### C. Export Performance

4. **Greece's export growth slowed in the second half of the 1990s, but recovered from 2002 onward as growth in the euro area and surrounding countries picked up.** As a result, after declining sharply during 1996–2000, Greece's share in world non-oil trade has stabilized in recent years.<sup>3</sup>

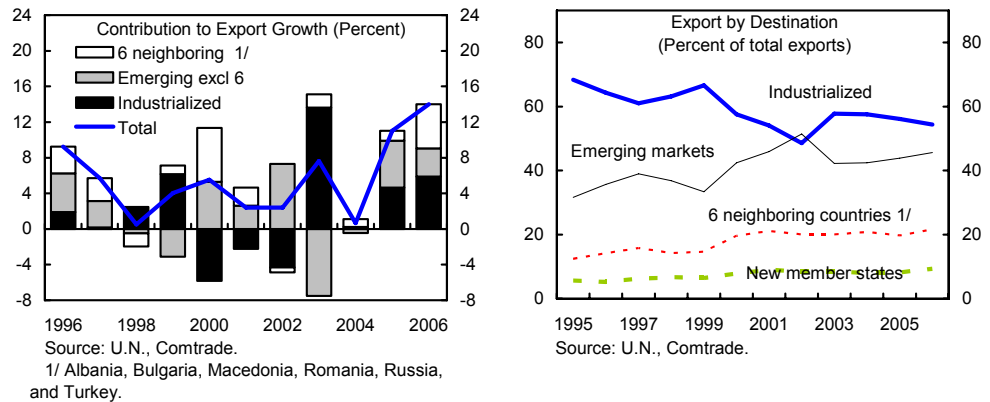
<sup>2</sup> For an explanation of these methodologies, see *Methodology for CGER Exchange Rate Assessments*, IMF, 11/8/06, <http://www.imf.org/external/np/pp/eng/2006/110806.pdf>. In view of the weaknesses in Greece's external sector data, these estimates should be treated with caution.

<sup>3</sup> Greece is an oil importing country, but it exports a sizable amount of petroleum products because of large refining operations in the country. To assess the impact of changing competitiveness of the goods that are primarily produced in Greece, the analysis in this paper focuses on exports excluding oil.



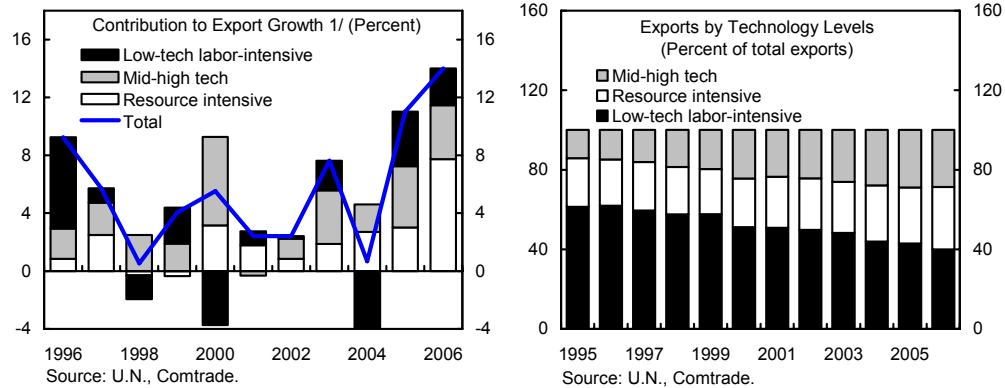
5. **Increasing diversification of trade away from mature industrialized countries toward rapidly growing areas in emerging markets has contributed to the recent buoyant performance of Greek exports.** The share of exports to emerging market countries has steadily increased from 30 percent in 1995 to close to 50 percent in 2006. Notably, exports to

emerging markets accounted for nearly half of the export growth in 2005–06. Among the emerging market countries, the



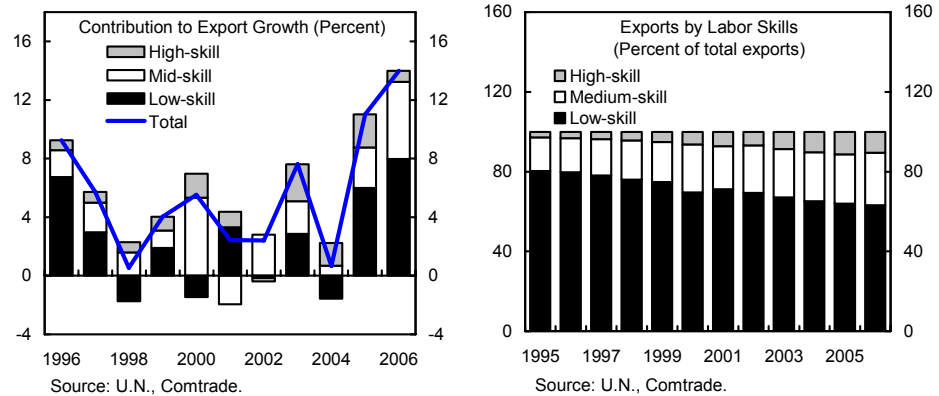
share of exports to EU new member states (NMS) increased from 6 to nearly 10 percent, expanding Greece’s market share. Outside the EU, sizeable gains were especially observed in exports to six countries (Albania, Bulgaria, Macedonia, Romania, Russia and Turkey) with their share in total exports increasing from 12 percent in 1995 to over 20 percent in 2006. In

contrast, Greece's market share in EU15 market has continued to decline, although it appears to have stabilized in other industrialized countries.



6. **Another factor underlying the recent pick-up in Greece's exports has been a shift in the composition of exports.** Classification of manufacturing industries by factor inputs<sup>4</sup> suggests

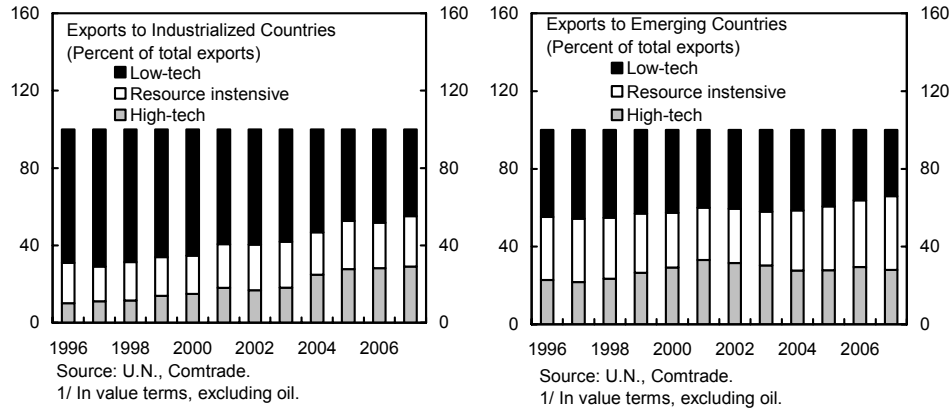
that the composition of Greek exports shifted away from low-tech and labor-intensive exports. The share of such products in total exports declined from



around 60 percent in 1995 to about 40 percent in 2006. At the same time, the share of medium-to high-tech exports has increased to about one-third of total exports. The share of resource-intensive exports has also edged up in recent years. In large part, medium- to high-tech products are exported to industrialized countries, while resource-intensive exports go to emerging markets. Similarly, the structure of exports based on labor-skill requirements<sup>5</sup> also has shifted away from low-skill products toward high-skill products. In terms of contribution to export growth, however, low-skill exports still have accounted for a significant share in 2005-06.

<sup>4</sup> Based on the classification by Landesmann. Low-tech and labor-intensive products include food, textiles, animal and vegetable oils, clothes, footwear, and leather products. Resource-intensive products include wood products, chemicals, metals, and nonmetallic mineral products. Medium- to high-tech products include machinery and transport equipment and electrical and optical equipment. For more details, see Table 1.

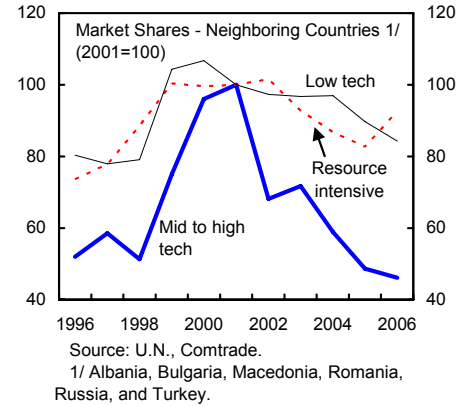
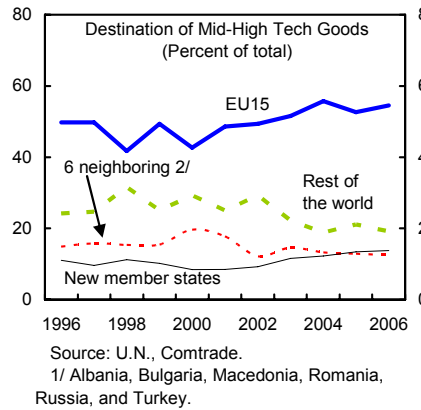
<sup>5</sup> Based on Stehrer (2003) and Peneder (1999 and 2001). For more details, see Table 1.



**7. However, there are risks that these favorable conditions may not be sustained.**

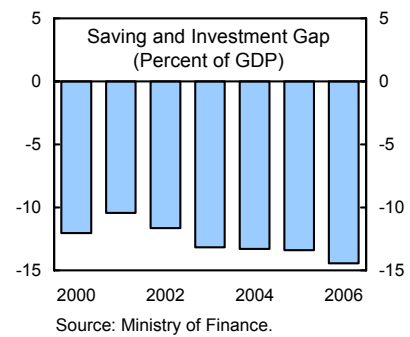
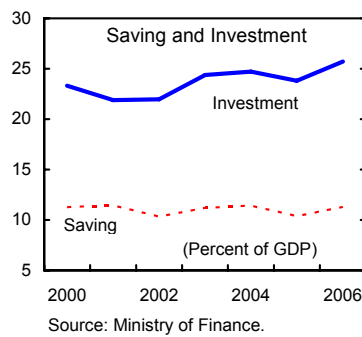
Greek exporters are already facing increasing competition in established neighboring markets

where exports mainly include resource intensive or low-tech labor intensive goods. Thus, notwithstanding rapid export growth, Greece's market share in these neighboring countries has been declining. In addition, many export-oriented labor intensive manufacturing firms are increasingly relying on outsourcing.<sup>6</sup>



**D. National Saving and Investment**

**8. A rapid increase in domestic investment and relatively stable national saving has accounted for the widening in the gap between national saving and investment in Greece since 2001.**<sup>7</sup>



The gap between national saving and investment increased from 10½ percent of GDP in 2001 to nearly 15 percent of GDP in 2006.

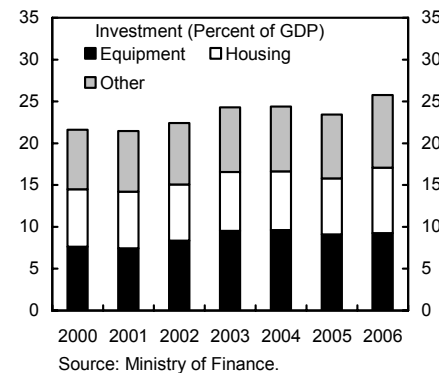
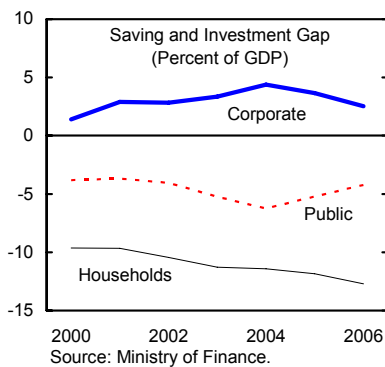
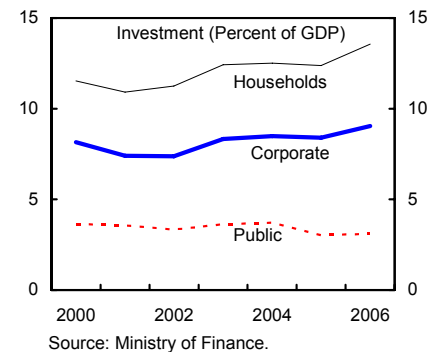
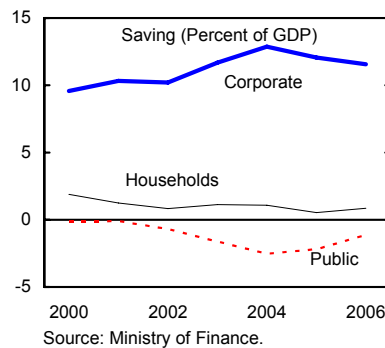
<sup>6</sup> European Commission, Sectoral Study 32/05, 2005.



9. **The household sector has accounted for most of the increase in the saving-investment gap.** Household saving declined during 2000-06, while residential investment recorded a steady pick-up. To a large extent, the decline in household saving and higher

demand for housing can be explained by the greater access to and demand for credit in the face of financial liberalization and lower interest rates associated with euro adoption. In contrast, the corporate sector was in a surplus position in the aggregate throughout the period, with rising saving exceeding investment. The notable increase in corporate saving over the period reflects the strong profitability of

the shipping and financial sectors. In the shipping sector, a significant jump in world freight rates and a rise in shipping volumes on the back of a hefty increase in world demand for oil and other minerals boosted the sector's profitability. In the financial sector, continued rapid credit growth and increasing exposure in the growing markets in southeastern Europe have been the key contributing factors. Against this background, corporate investment has picked up more recently, especially in equipment.



<sup>7</sup> There is a large statistical discrepancy between national accounts and balance of payments data in the range of 3-7 percent of GDP a year during 2000-06, which can not be easily reconciled. The discrepancy reflects differences in data source and methodology for external merchandise trade. National accounts are compiled using customs data and then adjusted in accordance with ESA 95 to include estimates for example for triangular merchanting trade, illegal activities, and smuggling. The balance of payments is compiled on the basis of bank settlements data.

With a significant fiscal consolidation underway and a decline in investment following the 2004 Olympics, the saving-investment gap of Greece's public sector has remained relatively constant in relation to GDP over the period.

**10. The widening in Greece's saving-investment gap has been similar to that in**

**Spain and Ireland.** In all three countries, the rise in gap has been largely attributable to an increase in investment.

Saving and Investment Changes, 2001–06

(Percent of GDP)

	Greece	Portugal	Spain	Germany	Ireland	France	Italy
Saving-investment gap	-4.0	0.7	-4.5	7.2	-3.1	-3.3	-2.3
Saving	-0.2	-4.2	-0.2	3.5	1.1	-2.3	-1.3
Investment	3.8	-4.8	4.2	-3.7	4.3	1.0	1.0

Source: Eurostat.

Table 1. Classification of Export Categories by Labor Skills and Factor Intensity

2-digit Category (SITC revision 3)		Taxonomy skills	Labor Taxonomy Intensity	Factor
00	Live animals except fish	Low-tech, labor intensive	Low-skill	
01	Meat and preparations	Low-tech, labor intensive	Low-skill	
02	Dairy products and eggs	Low-tech, labor intensive	Low-skill	
03	Fish/shellfish/etc.	Low-tech, labor intensive	Low-skill	
04	Cereals and cereal preparations	Low-tech, labor intensive	Low-skill	
05	Vegetables and fruit	Low-tech, labor intensive	Low-skill	
06	Sugar, sugar preparations and honey	Low-tech, labor intensive	Low-skill	
07	Coffee, tea, cocoa, spices	Low-tech, labor intensive	Low-skill	
08	Animal feeding	Low-tech, labor intensive	Low-skill	
09	Misc. food products	Low-tech, labor intensive	Low-skill	
11	Beverages	Low-tech, labor intensive	Low-skill	
12	Tobacco/manufactures	Low-tech, labor intensive	Low-skill	
21	Hides, skins and fur skins	Low-tech, labor intensive	Low-skill	
22	Oil-seeds and oil fruits	Low-tech, labor intensive	Low-skill	
23	Crude rubber	Resource intensive	Medium-skill white collar	
24	Cork and wood	Resource intensive	Medium-skill blue collar	
25	Pulp and waste paper	Resource intensive	Medium-skill white collar	
26	Textile fibers	Low-tech, labor intensive	Low-skill	
27	Crude fertilizers/mineral	Resource intensive	Medium-skill white collar	
28	Metal ores and metal scrap	Resource intensive	Low-skill	
29	Crude animal and vegetable	Low-tech, labor intensive	Low-skill	
32	Coal, coke and briquettes	Resource intensive	Low-skill	
33	Petroleum and products	<i>Excluded</i>	<i>Excluded</i>	
34	Gas natural and manufactured	<i>Excluded</i>	<i>Excluded</i>	
35	Electric current	Resource intensive	Medium-skill blue collar	
42	Fixed vegetable fats and oil	Low-tech, labor intensive	Low-skill	
43	Animal or vegetable fats	Low-tech, labor intensive	Low-skill	
51	Organic chemicals	Resource intensive	Medium-skill white collar	
52	Inorganic chemicals	Resource intensive	Medium-skill white collar	
53	Dyeing, tanning and color materials	Resource intensive	Medium-skill white collar	
54	Pharmaceutical products	Medium-to high tech	High-skill	
55	Perfume, cosmetic, and cleansar	Medium-to high tech	Medium-skill white collar	
56	Fertilizers	Resource intensive	Medium-skill white collar	
57	Plastics in primary forms	Resource intensive	Medium-skill white collar	
58	Plastics in non-primary forms	Resource intensive	Low-skill	
59	Chemical materials and products	Resource intensive	Medium-skill white collar	
61	Leather manufactures	Low-tech, labor intensive	Low-skill	
62	Rubber manufactures	Resource intensive	Low-skill	
63	Cork and wood manufactures	Resource intensive	Medium-skill blue collar	
64	Paper, paperboard, articles	Resource intensive	Medium-skill white collar	
65	Textile yarn, fabrics, art.	Low-tech, labor intensive	Low-skill	
66	Non-metallic mineral manuf.	Resource intensive	Low-skill	
67	Iron and steel	Resource intensive	Low-skill	
68	Non-ferrous metals	Resource intensive	Low-skill	
69	Metal manufactures nes	Resource intensive	Low-skill	
71	Power generating equipment	Medium-to high tech	Medium-skill white collar	
72	Industry special machine	Medium-to high tech	High-skill	
73	Metalworking machinery	Medium-to high tech	High-skill	
74	General industrial machinery	Medium-to high tech	High-skill	
75	Office machines	Medium-to high tech	High-skill	
76	Telecommunications/sound equipment	Medium-to high tech	Medium-skill white collar	
77	Electrical equipment	Medium-to high tech	Medium-skill white collar	
78	Road vehicles	Medium-to high tech	Medium-skill blue collar	
79	Other transport equipment	Medium-to high tech	Medium-skill blue collar	
81	Prefabricated buildings	Medium-to high tech	Low-skill	
82	Furniture and parts	Medium-to high tech	Medium-skill blue collar	
83	Travel goods, handbags	Low-tech, labor intensive	Low-skill	
84	Apparel/clothing/access	Low-tech, labor intensive	Low-skill	
85	Footwear	Low-tech, labor intensive	Low-skill	
87	Professional/scientific instrument	Medium-to high tech	Medium-skill white collar	
88	Photographic equipment, clocks	Medium-to high tech	Medium-skill white collar	
89	Miscellaneous manuf.	Medium-to high tech	Medium-skill blue collar	
96	Coin nongold non current	Resource intensive	Low-skill	
97	Gold non-monetary ex ore	Resource intensive	Low-skill	

Sources: Peneder (1999) and Landesmann and Stehrer (2003).

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## II. BROADENING THE TAX BASE<sup>1</sup>

### A. Introduction

1. Following years of piecemeal changes, Greece has been implementing tax reform since 2002 in a phased manner:
  - **In 2002**, the authorities simplified record keeping, eliminated a number of duplicative taxes, reformed the personal income tax, streamlined VAT administration, and increased the use of electronic technologies.<sup>2</sup>
  - **During 2004–07**, the authorities unified the taxation on interest income, eliminated tax exemption on retained earnings for certain industries, extended the VAT to real estate transactions, and strengthened tax administration by stepping up tax audits and cross verifications. More generally, the emphasis was on reducing direct taxation and increasing indirect taxes.
  - **In 2008**, the authorities have initiated measures to expand the tax base further, including by combating evasion. A new tax evasion law has been introduced, the taxation of gasoil has been harmonized, and a broad-based property tax has entered into force. In addition, as part of a planned reduction in direct taxation, a second round of personal income tax rate cuts will be phased in during 2008–09.
2. **However, there is still considerable scope for further simplifying the tax system and broadening the tax base.** The tax ratio in Greece will need to rise over the medium term to meet the fiscal consolidation objective and to deal with fiscal pressures of population ageing. It would be desirable to raise the tax ratio through expanding the tax base, before considering raising tax rates.
3. **This chapter discusses the areas for base broadening.** Section B examines the Greek tax ratio and structure, and places them in the EU context. Sections C through G review the design of the various tax categories and identify the scope for base broadening: personal income tax (section C), corporate income tax (section D), value added tax (section E), excises (section F), and property taxes (section G). Section H concludes.

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<sup>1</sup> Prepared by Dale Chua.

<sup>2</sup> For details, see OECD (2001), and Lutz (2003).

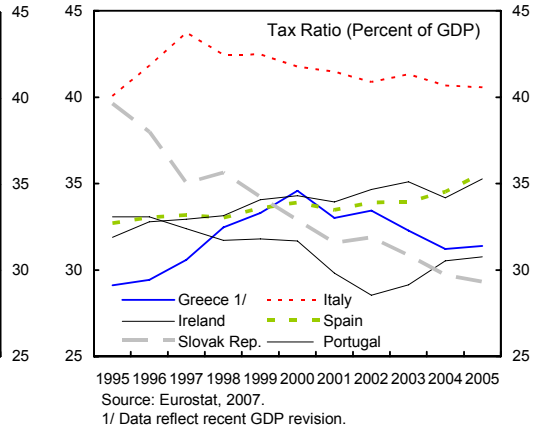
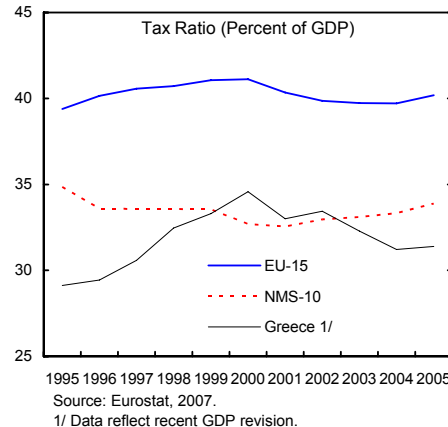
## B. Tax ratio and tax structure

### Tax ratio

4. **Greece has a low tax ratio for an EU-15 country. During 1995-2005**, Greece's tax-to-GDP ratio averaged 31.9 percent of GDP<sup>3</sup>—8.5 percentage points of GDP below the EU-15

average and 1.5 percentage points of GDP lower than the NMS-10 average.

Greece's tax ratio ranked 20<sup>th</sup> among the EU-25 in 2005,



surpassing only Ireland, the three Baltic States, and Slovakia.<sup>4</sup> Total revenue (including social contributions) peaked in 2000 at 34.6 percent of GDP due to efforts to reduce the government deficit before euro adoption. Thereafter, the tax ratio declined to 31.4 percent of GDP in 2005 as the authorities took measures to reduce the tax burden (mainly on labor and corporate income) and eliminated distortionary taxes to simplify the tax system.

5. **The tax ratio in Greece is low due in part to tax evasion.** To deal with the longstanding problem of evasion, the authorities have stepped up administrative efforts to improve tax compliance, focusing on intensifying tax audits and cross verification that have already produced some positive results. They have also introduced new anti-fraud and tax evasion legislation, which among other things provides for the creation of a National Council to guide efforts in tackling evasion. The law also provides tax incentive for taxpayers to collect receipts as a means to combat under-reporting of income. In addition, to curb excise fraud, the taxation of gasoil for heating and propellant use has been unified.

6. **Equally important, the low tax ratio is also the result of a particularly narrow base.** With limited exceptions (such as excise rates on energy products), tax rates in Greece are not low by most standards. The low tax ratio is a result of poor compliance and weak policy design that gives rise to a highly complex tax system with a narrow base.

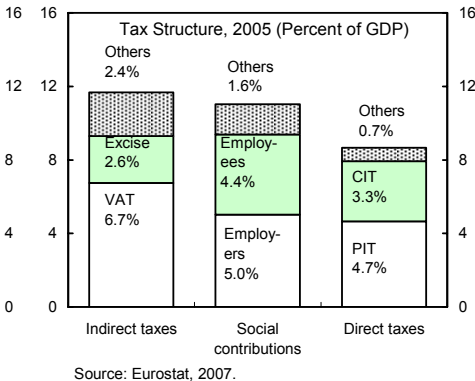
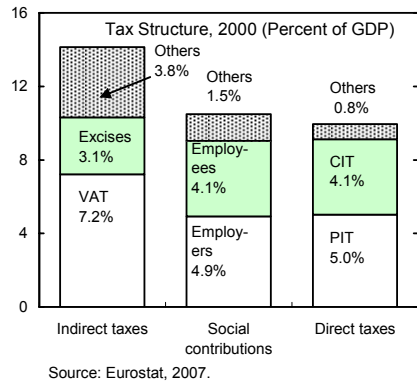
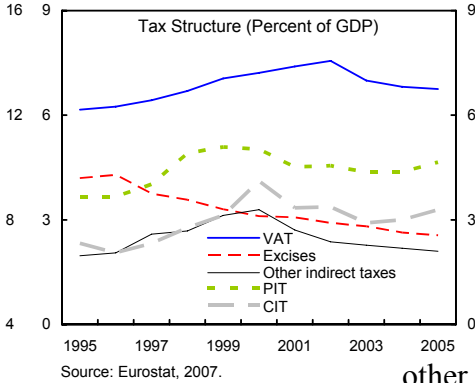
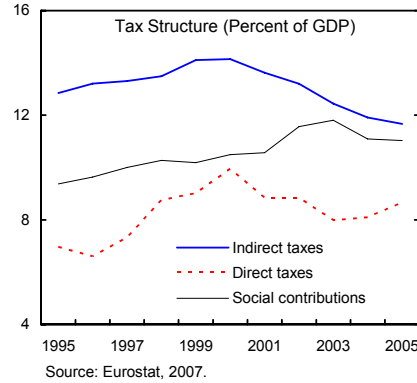
<sup>3</sup> Data from Eurostat are adjusted for recent GDP revisions. Eurostat uses the ESA 95 reporting framework, which provides data on an accrual basis.

<sup>4</sup> EU-wide data are available up to 2005 (see, Eurostat, 2007).

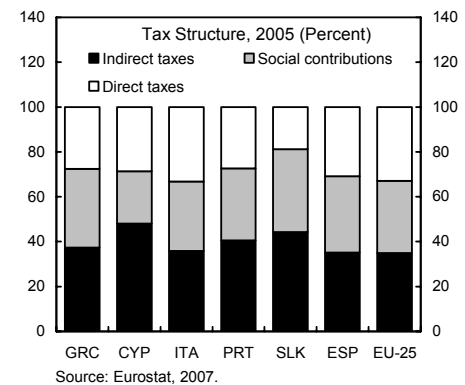
**Tax structure**

7. **The share of indirect taxes and social contributions in total revenue in Greece is relatively high while that of direct taxes is relatively low.** During 1995-2005, as ratio to GDP, indirect taxes averaged 13.1 percent, social contributions 10.5 percent, and direct taxes 8.3 percent. A few broad trends are discernible. First, social contributions have risen over time. Second, indirect taxes in the aggregate have declined since 2000, led initially by the decline in excises and indirect taxes, and joined by the VAT after 2002. Third, direct taxes in the aggregate also have fallen as ratio to GDP since 2000, reflecting in particular

purposeful reforms to reduce personal and corporate income taxation.



8. **Compared with other countries in the European Union, indirect taxes in Greece are not high, but personal income taxes are particularly low and social contributions are relatively high.** In 2005, Greece ranked 13<sup>th</sup> for VAT, 17<sup>th</sup> for excise, and 20<sup>th</sup> for direct taxes among the EU-25.<sup>5</sup> The low personal income tax collections reflect Greece's challenge to bring into the tax system the large number of small businesses and



<sup>5</sup> In 2005, the EU-25 collected 13.8 percent of GDP in indirect taxes on average, while Greece collected only 11.8 percent of GDP. The average direct tax collection in the EU-25 was 13.2 percent of GDP compared to 8.7 percent of GDP in Greece.

self-employed who operate in the informal sector in the economy.<sup>6</sup> In contrast, Greece is in 8<sup>th</sup> place for social contributions among the EU-25.<sup>7</sup> The structure of the Greek tax system is broadly similar to that of Cyprus and Portugal, in that the share of direct taxes in total tax revenue is low.

### Low income tax but high labor tax wedge

9. **While income tax collection in Greece is on the low side, the labor tax wedge is not.** According to OECD estimates, a single Greek taxpayer (with no children) earning the average wage in 2006 would pay 8.7 percent of his earnings in taxes—less than one half the EU-15 average.<sup>8</sup> The relatively low effective average tax rate—an indication of the narrowness of the tax base—together with widespread tax evasion, explains the low personal income tax collection. On the other hand, social taxes are high in Greece (44.06 percent or 50.66 percent of gross monthly remuneration, including bonuses and fringe benefits).<sup>9</sup> Accounting for social contributions and government transfers to households, the “net” tax wedge on labor income in Greece would rise substantially.<sup>10</sup> Because social taxes in Greece are high and government cash transfers to household are less generous, the net tax wedge on labor income in Greece for most family types is higher than the average of the EU-15.

Income and Social Taxes, by Family-Type and Wage Level, 2006

Family-type:	Single	Single	Single	Single	Married	Married	Married	Married
Number of children:	None	None	None	2	2	2	2	None
Wage level (percent of average wage):	67	100	167	67	100-0	100-33	100-67	100-33
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Income tax (percent of gross wage earnings)								
Greece	1.2	8.7	17.3	0.4	9.1	7.1	6.3	7.8
EU-15	12.3	17.6	25.6	7.4	11.5	11.9	13.9	13.5
Income tax plus total net social contributions (percent of gross wage earnings)								
Greece	35.4	41.2	47.9	34.7	41.5	40.0	39.3	40.5
EU-15	38.1	42.6	47.7	22.2	32.1	33.5	36.6	38.6

Source: OECD, Taxing Wages, Tables I.1. and I.4.

<sup>6</sup> The share of the informal sector in GDP in Greece is estimated at between 25 to 35 percent.

<sup>7</sup> In 2005, the average social contribution in the EU-25 amounted to 12.8 percent of GDP, compared to 11 percent of GDP in Greece.

<sup>8</sup> Simulations for other family types showed similar results. These include single taxpayer earning 67 percent and 167 percent of the average wage, single family household with two children earning 67 percent of the average wage, two-income households with two children (where the main income earner earns the average wage and the secondary income earner at zero, 33 percent, and 67 percent of the average wage) and two-income household without children.

<sup>9</sup> Social taxes on workers are 16 percent or 19.45 percent (depending on the type of job) and on employers 28.06 percent or 31.21 percent.

<sup>10</sup> Total net social contribution includes personal income tax, total employee and employer social contributions less social transfers.



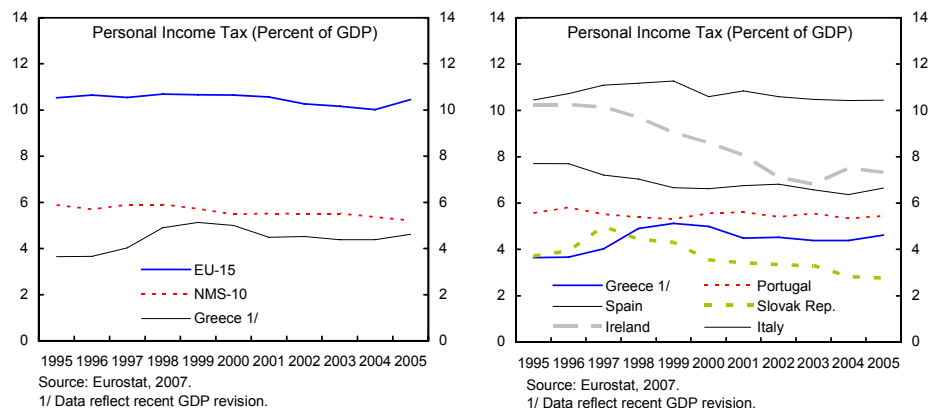
## Need for base broadening and a better tax mix

10. **Efforts to increase the tax ratio must first aim at broadening the base.** While the tax ratio is relatively low, serious tax evasion problems in Greece imply that the tax burden on those who do pay taxes can be high. Thus, recent stepped up efforts to improve compliance are apt. However, more effort is needed in order to meet the balanced-budget target by 2010 and in view of the long-term fiscal pressures associated with mounting pension and healthcare costs of population ageing. If the tax ratio has to rise, which taxes should be increased? As argued below, the scope for broadening *all* major tax bases is considerable in Greece and ought to take precedence over an increase in tax rates. After all, a basic tenet of any tax reform must be to broaden and get the tax base right, while the appropriate tax rates will be decided by revenue needs.

11. **Theory can point to areas that can help improve Greece's tax mix if it seeks to increase its tax ratio.** To minimize the welfare cost of raising any amount of tax revenue requires a balance between the available tax instruments. Public finance theory tells us that, at the optimum, the marginal welfare cost of raising an additional euro must be equal across all taxes. While it would be desirable to estimate the welfare cost for the entire range of tax instruments in any country, this is rarely done. Instead, guided by theory, tax practitioners generally accept that the lowest welfare cost of a tax is one that least distorts economic behavior and has a minimum impact on real income distribution. This leads to the following implications: on one extreme, capital income taxes because of uncertainty on their final incidence and increased tax sensitive of the domestic base due to continued international capital mobility, involve high welfare cost. On the other extreme, property taxes because they are levied on a base that lacks mobility and concentrated in the hands of the better off, involve low welfare cost, at least at moderate level of taxation. In between these taxes, the welfare cost of trade taxes is likely to be high given its impact on production, while consumption-based taxes such as the VAT, which is more supportive of growth, and excises especially on energy products, which are supportive of the environment, are likely to have a lower welfare cost than income-based ones such as the personal income tax and capital taxes, which affect intertemporal prices.

### C. Personal Income Tax

12. **Personal income tax (PIT) collection in Greece is particularly low as ratio to GDP. During 1995-2005, Greece PIT revenue**



averaged 4.4 percent of GDP—some 42 percent of the EU-15 average, and 80 percent of the new EU-member states (NMS-10) average. Even though PIT performance has improved somewhat in recent years, it would take considerable effort before it catches up to the EU average. What explains the low yield? The factors point predominantly to a narrow base rather than low rates. Thus, the focus for improving the PIT rests in base broadening, reducing complexity, strengthening compliance, and ensuring that the self-employed pay a fair share.

13. **PIT rates in Greece fall around the middle in a wide spectrum of PIT rates in the region.** PIT systems in Europe differ widely from one country to another—for instance, from highly progressive taxation on labor income in the Nordic countries to a flat tax in the Baltic States and Slovakia. However, a commonly shared EU feature is that statutory rates have been coming down at all income levels.<sup>11</sup> Nearly all EU-15 member states have cut their top marginal tax rates in the last decade and many also have reduced rates at lower income brackets. In Greece, the phasing-in of the PIT reform entails further rate cuts in 2008 and 2009, and an expansion of the tax-exempt threshold.<sup>12</sup> These rate cuts are likely to have some, but not an overwhelming, negative impact on revenue.

14. **The Greek PIT is complex, reflecting responses to domestic and outside pressures over time.** It contains elements of dual income tax (DIT) and global income tax (GIT) (see Box 1). Yet, in some respects, it is more complex than both. Like a DIT, the PIT taxes capital income at lower rates than non-capital income. However, it is more complex than most DIT in that capital income is taxed at different rates, some final and others not.<sup>13</sup>

15. **Like a global tax, the PIT taxes all sources of income (seven categories<sup>14</sup>) at progressive rates.** Where provided by law, allowances and expenses are deducted from gross income of each source. The remaining taxable income from each source is then aggregated across different sources. Loss offset from one category is allowed against gain from another. The PIT has two progressive rate structures, depending on the type of income. In addition, certainly rare, if not unique, the tax-exempt threshold depends on the number of children and the PIT offers numerous nonstandard deductions and tax credits. An additional

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<sup>11</sup> See, OECD (2006a), page 2.

<sup>12</sup> The tax exempt income was increased from EUR 11,000 to EUR 12,000 in 2007 for labor income and from EUR 9,500 to EUR 10,000 for nonlabor income. Details of rate cuts are discussed below.

<sup>13</sup> For example, interest income from banks and corporates are taxed at final withholding of 10 percent, but dividends are effectively taxed at a higher rate of 20 or 25 percent at the company level before distribution. In addition, capital gains may be exempt, taxed at various rates as a *final* tax if held by an individual, or taxed at the corporate rate if held by a business entity.

<sup>14</sup> They are business/trading, professional, partnership, agricultural, employment, immovable property, movable property.

1.5 percent income surtax is imposed on rental income from land and buildings.<sup>15</sup> There is no local income tax in Greece.

### **Box 1: Main Approaches to Taxing Personal Income**

There are three approaches to taxing personal income; namely, the global income tax (GIT), dual income tax (DIT) and the flat tax.

The **GIT** approach taxes in a comprehensive manner the sum of the taxpayer's income from *all* sources, typically under a progressive rate structure. The GIT normally provides significant tax deductions and allowances that tend to increase in value as income level raises. Its main advantages are that (1) taxpayers with the same level of income, regardless of how that is earned, are treated in the same way and (2) it eliminates the incentive for taxpayers to transform one form of income into another for tax purposes. However, the GIT suffers from (at least) two problems: some forms of income are hard to tax because they are difficult to observe (for example, unrealized capital gains), and the inability to tax capital income at marginal rates as high as those of labor income because of increased capital mobility. Hence, countries that might have once advocated a GIT (for example, the U.S., Canada, and U.K.) have in fact implemented hybrids that exclude part or all of returns on saving and investment, subjecting them to reduced taxation, often imposing a final withholding tax at a fairly low rate compared to the top marginal rate under the GIT.

The **DIT** approach is a compromise between the progressive GIT and the purely flat tax. Most well known for its application in the Nordic countries, the DIT approach levies a singular (usually), low tax rate on capital income and progressive rates on the sum of other labor and other noncapital income. Indeed, the DIT is essentially a form of schedular tax, which separates out capital and noncapital income. In the purest form, the DIT respects two properties. First, the rate on capital income is aligned with the corporate tax rate and the marginal tax rate on labor income in the first bracket. Second, it should have only one rate and no exemptions so as to achieve the greatest degree of uniformity and neutrality in taxing capital income. The DIT approach effectively acknowledges the severe limitation of progressive taxation on capital income as a way to redistribute income. The redistributive goals under the DIT come from the progressive taxation on noncapital income.

The **flat tax** approach levies a proportional (flat) tax rate on all sources of income (after permissible deductions). Adopted mainly in Eastern Europe, the main appeal of a flat tax system is simplification and transparency, which could help strengthen tax administration and enforcement. In theory, this could lead to better compliance (although it remains too early to judge). While a flat tax can still be mildly progressive (depending on the level of tax exempt income), a singular rate severely restricts the ability of the personal income tax to redistribute income, which limits its appeal to countries with strong consensus for progressivity in the income tax. Countries adopting the flat tax (for example, Slovakia) have tended to shift the tax burden from direct to indirect taxes, while maintaining high social contribution taxes.

16. **The key to increasing the PIT revenue yield lies in simplifying and improving the following areas.** While it may be helpful to have a coherent framework along the lines of a GIT, DIT or flat tax, Greece cannot escape implementing reform to (1) broaden the base, (2) simplify the rate structure, and (3) rationalize capital income taxation.

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<sup>15</sup> This proportional surtax subject to a cap must not exceed the tax levied on the taxpayer's total taxable income.

## Broadening the base

17. **The scope for broadening the PIT base is considerable** because of generous deductions and tax credits, exempt income, and tax evasion by the self-employed and underreported income from workers in the informal sector. The main priorities are:

- **Controlling nonstandard tax credits and deductions.** The PIT offers a standard personal deduction of EUR 2,400 (and additional standard deduction for supporting handicapped person supported by the taxpayers), and a standard tax credit of EUR 240 for education expenses for self and each dependent. It also has a large number of nonstandard deductions and tax credits,<sup>16</sup> some subject to cap and some not (see Appendix I). Consideration should be given to substituting targeted expenditure programs for nonstandard deductions and tax credits. Greece—like many countries—has standard relief (such as personal deduction) to assist individual taxpayers. However, it also employs a large number of base narrowing nonstandard deductions and credits for the pursuit of various public policy objectives (including alimony payment, energy installation, interest mortgage). These nonstandard deductions and credits can also be unfair to certain taxpayers who are not in the position to benefit from them because of individual circumstances.<sup>17</sup> In addition, certain nonstandard reliefs can benefit the better off disproportionately (although the ceilings in the law will limit their impact). Thus, best practice calls for curbing nonstandard reliefs. It is often fairer, more cost effective and transparent to adopt well-targeted expenditure programs for pursuing the policy goals which nonstandard reliefs are designed to achieve.
- **Reining in exempt income.** While most incomes are subject to tax, several are not. For instance, tax exempt income include pensions for veterans, salaries and pensions for handicapped, monetary awards from the Greek state, certain capital gains from the sales of immovable property, income from derivative transactions carried out on the Athens Derivatives Exchange, subsidies paid to young professionals and entrepreneurs, and benefits for third and subsequent child. To broaden the tax base, considerations could be given to narrowing this list by bringing into tax, in the first instance, capital gains of immovable property, profits from derivative income and subsidies to young professionals.

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<sup>16</sup> A nonstandard relief is defined as a deduction or credit whose amount is determined by reference to the actual expenses incurred. In contrast, a standard relief is available to all taxpayers satisfying eligibility rules and is unrelated to actual expenditure.

<sup>17</sup>As a rule, tax credit is more progressive than a deduction for any progressive rate structure. For example, a deduction of EUR 1,000 reduces the tax liability of taxpayer in the 25 percent bracket by EUR 250 and a taxpayer in the 40 percent bracket by EUR 400. A tax credit of EUR 250, in contrast, reduces the liability of both by the same amount.

- **Taxing the self-employed and the informal sector.** Greece has a large number of self-employed and a large informal sector.<sup>18</sup> Taxing the self-employed is difficult in all countries. In Greece, it is exacerbated by a weak book keeping culture and an outdated approach to tax administration. In 2005, a Fund technical assistance mission on tax administration found that tax evasion was a serious problem that undermined revenue and imposed a high cost on those in the formal economy. Poor compliance is believed to be particularly acute amongst the self-employed and those working in the shadow economy. While this leads to a serious narrowing of the tax base, it also is a basic unfairness that may undermine compliance more broadly.
- **Simplifying the tax system.** Part of the poor compliance may be due to the complexity of the tax system, weak tax paying culture, and poor enforcement. Thus, Greece should consider adopting every simplification that moves in the direction of improving transparency. Reducing compliance cost would be beneficial for revenue and help reduce evasion. As noted, the authorities have stepped up efforts to strengthen tax administration, including intensive auditing and cross verifications. In addition, the new evasion law provides a deduction for taxpayers to collect receipts, an incentive that may have a potential positive impact but would need to be carefully watched (it can be abused by false invoices). The National Council, tasked with the charge of combating evasion, could consider laying out a strategy with reinvigorated efforts to ensure that the self-employed pay their fair share of tax. Beyond that, stronger enforcement of penalties, which on paper are severe, could be helpful.<sup>19</sup>

### **Simplifying the rate structure**

18. **The PIT is complex because of multiple progressive rate structures for individuals and multiple tax rates for partnerships.** Several changes could be made to simplify the system:

- **Rate structures for individuals.** Greece has basic two progressive rate structures—one for labor (including pension) income with four brackets (including the zero rate bracket), and another for nonlabor income with five brackets (including the zero rate bracket). Both structures have a zero marginal rate (for income below EUR 10,500) and three marginal rates of 29 percent (for income between EUR 12,001 and 30,000),

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<sup>18</sup> In a 2000 CESifo paper, Freidich Schneider estimated that the size of the shadow economy in Greece was 29.6 percent, the largest of 18 OECD countries in the study.

<sup>19</sup> These include heavy monetary fine and prison terms for nonpayment and tax frauds, which are seldom enforced. For example, fine is set at 1.5 percent per month up to 300 percent of tax and imprisonment of up to 10 years for tax evasion exceeding euro 150,000.

39 percent (EUR 30,001 and 75,000), and 40 percent (above EUR 75,000).<sup>20</sup> Thus, the only difference between the two structures lies in the treatment over a narrow income bracket (EUR 10,500 to 12,000). Labor income is exempt in this bracket while nonlabor income attracts a marginal rate of 15 percent over this income range. The slight tax preference for labor income, which is a compensation to wage earners since nonwage income earners may deduct various expenses (either legally or illegally to evade taxation), adds to the complexity of the tax system. As the small gap is unlikely to amount to any significant real difference for wage or nonwage earners, consideration could be given to having only one rate structure. In addition, the tax-exempt bracket under both rate structures is dependent on the number of children, increasing by EUR 1,000, EUR 2,000 and EUR 10,000 respectively, for one, two and three dependent children. There is an additional EUR 1,000 increase for each subsequent child after the third. While using the tax system to assist family with children is common, modern approaches stress tax equality for taxpayers independent of the number of children in the household. Governments can better handle the public policy goal of promoting family and children through targeted social programs, thus reducing the cost of the policy goal while improving its transparency.

- **Tax rates for partnerships.** Profits of limited liability companies (*eteria periorismenis efthinis*, *EPE*, a form of partnership) are treated as business income (irrespective of whether it is a trading business or a partnership of professionals, except lawyers). EPEs are taxed at a 25 percent flat rate. Profits of other types of partnerships (*eterorithmos eteria EE*, *omorithmos eteria*, *OE* and *astiki eteria*, *Ast. Et*) are also treated as business income, unless their business activity falls specifically into professional class such as lawyers, doctors, dentists, business consultants, etc. The latter are taxed at a flat rate of 20 percent. There are also special rules of deduction against profits: OE may deduct up to 50 percent of profits as salary for its administrators, who must be shareholders. This different tax treatment distorts the choice in the organization of partnerships. In fact, many countries treat partnerships as “flow-through” entities—under which income is not taxed at the partnership level, but distributions to partners are taxed under the PIT at progressive rates. Greece can usefully consider this reform option, which can help remove tax arbitrage opportunity, and equalize the tax treatment of partners and self-proprietors.

## **Rationalizing personal capital income taxation**

**19. The PIT recognizes interest income, dividends, and capital gains as different form of capital income.** At a broad level, capital income is subject to a schedular final tax

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<sup>20</sup> The rates of 29 percent and 39 percent of both progressive structures will be reduced to 27 percent and 37 percent respectively in 2008, and further to 25 percent and 27 percent in 2009 and beyond. The rate structure is quite progressive, in 2005, the tax-exempt threshold is equal to 0.6 times per capita GDP and the top marginal rate threshold that is below the OECD average (or equivalent to just 3.8 times per capital GDP).

when received by individuals. In practice, the system is more complex because of exemption and significant rate differential, and also because taxation depends on the source of income produced (locally or overseas). As shown in the text table below, interest income is subject to a final withholding tax of 10 percent if received by individuals, but at 25 percent (with credit for taxes withheld) if received by corporations. In addition, interest income on non-euro deposits with a Greek bank held by a foreigner is tax exempt. Domestic dividends are effectively taxed at the company level, at 20 or 25 percent, while foreign-source dividends are taxed at progressive marginal rates (with credit given for foreign taxes paid). Dividends from shipping operations are taxed at a reduced presumptive rate. Capital gains are either exempt (for example, income from derivative transactions) or subject to a schedular final tax at different rates.<sup>21</sup> Gains from immovable property are either exempt or taxed up to 20 percent, depending on the holding period. Gains not explicitly listed, such as rights to purchase real property, are exempt.

#### Taxation of Personal Capital Income

Personal Capital Income	Exempt	Schedular Tax	Global Income Tax
Interest	Interest from non-euro deposits	Interest from Greek banks and Postal Savings Bank (10%)	
Dividends	Dividends paid from shipping companies under tonnage regime 1/	Other dividends are taxed at the company level at either 20% or 25%	Foreign-source dividends are taxed at progressive marginal rates
		Gains from shares are taxed at 5% (unlisted corporation) or 20% (partnerships and corporations)	
Capital gains from shares, participation, etc	Gains derived from Athens Derivative Exchange	Gains from transfer of a participation to relatives are taxed at 1.2% or 2.4%	
		Gains from sales of a name, trademark, and goodwill are taxed at 20%	
Capital gains from real estate	Gains from immovable property held over 25 years	Gains from immovable property held up to 5 years (20%)	
	Gains not explicitly listed, such as rights to purchase real property	5-15 years (10 %) 15-25 years (5%)	

1/ Dividends from shipping operations are effectively taxed at a reduced rate at the company level under the presumptive tonnage regime.

<sup>21</sup> For instance, gains from shares and participation are taxed at 1.2 percent or 2.4 percent if sold to a relative, 5 percent if the company is unlisted, and 20 percent if listed.

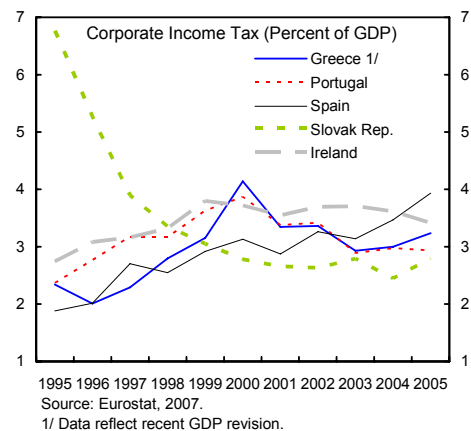
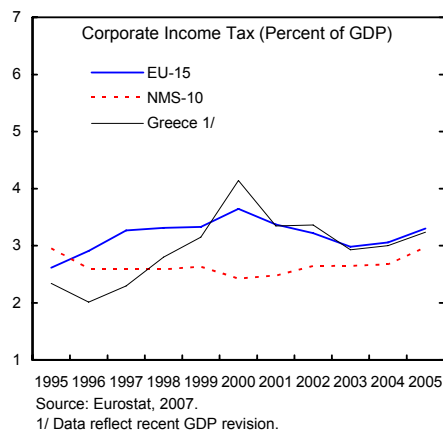
20. **The complexity in the taxation of capital income has several undesirable outcomes.** First, exempting capital gains from derivative transaction and property held over 25 years narrows the base. Second, different tax treatment leads to non-neutrality in the taxation of capital income. It offers opportunity for tax arbitrage (for example, disguising one form of income as another, or converting wages into dividends or capital gains). Third, lower capital gains on immovable property favors the investment in residential housing, which also enjoys a tax credit on interest on mortgage loan, at the expense of investment in other productive assets. Lastly, excluding some capital gains from taxation weakens the distributive role of the PIT.

21. **Greece could further study how best it would like to tax capital income.** The complexity in Greece—also observed in other countries—reflects tensions between the policy seeking to encourage investment and savings and the redistributive goal of an income tax. It is also a sign that in a world of capital mobility, such income is increasingly taxed at reduced rates. Under a GIT, all sources of capital income will be brought into tax at the same progressive marginal rates. The approach would require eliminating exemptions; taxing dividends at the personal level (with a gross-up for taxes paid at the corporate level and a dividend tax credit for the same amount); and abolishing differential taxation of capital gains (by rates, holding period, or other criterion). Under a DIT, all sources of capital income—defined to include interest, dividends, capital gains (from real property and financial assets), and other form of financial income (such as derivatives and insurance policies)—would be harmonized.

#### D. Corporate Income Tax

22. **The corporate income tax (CIT) has been a relatively important source of revenue for Greece.** The CIT is levied on resident corporations or limited share companies

(*anonymos eteria*, AEs), resident limited liability companies (*eteria periorismenis efthinis*, EPEs)<sup>22</sup>, state-owned enterprises, cooperatives, and



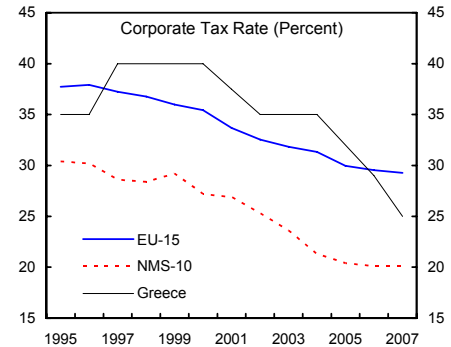
nonresident enterprises operating. During 1995-2005, CIT revenue averaged 3.0 percent of

<sup>22</sup> EPE is a hybrid of the AE and the partnership. EPE owners enjoyed limited liability (as in the AE) and they may be more personally involved in management (as in the partnership).



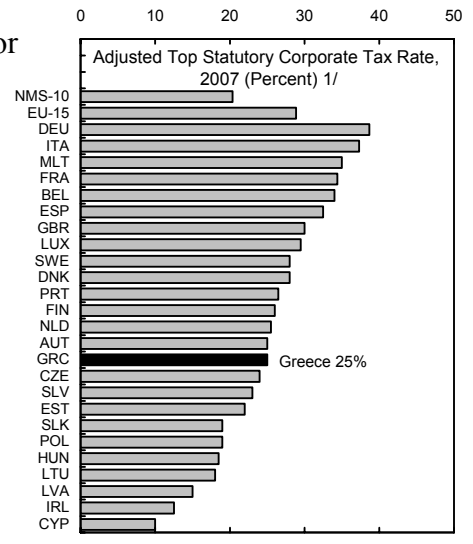
GDP—slightly lower than the EU-15 average (3.2 percent), but higher than the NMS-10 average (2.7 percent). However, following the 2004 reform that entailed a phased reduction in CIT rate, corporate tax revenue has declined as ratio to GDP.

23. **In line with EU and worldwide trends, the CIT rate in Greece has fallen substantially.** In a phased reduction, the singular CIT rate was progressively cut from 35 percent to 32 percent in 2005, to 29 percent in 2006 and to 25 percent in 2007. These cuts put Greece’s CIT rate at well below the EU-15 average (29.5 percent). However, it remains relatively high compared to average of the NMS-10 (20.1 percent).



Source: KMPG Corporate Tax, various years.

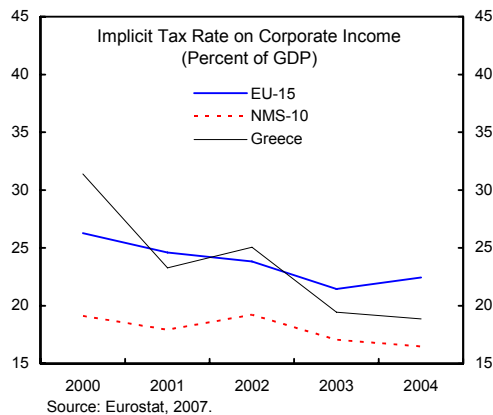
24. **Greece does not levy surcharges or local taxes on corporate profits.** Unlike in several EU countries (for example, Germany and Luxembourg) which have subnational corporate taxes and/or levy a surtax on corporate profits, there are no further “add-ons” to the Greek central government corporate tax. Thus, Greece has the lowest corporate rate among the EU-15 (save Ireland) when the add-ons are included. However, the Greek corporate rate is still high compared to the NMS-10 (save Malta) which, like Greece, do not generally have a sub-national level tax on corporate profits.



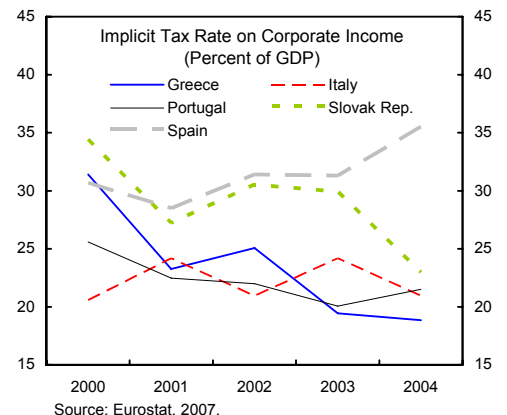
Source: Eurostat 2007.  
1/ Adjusted for surcharges and local taxes, when applicable.

25. **The CIT as a source of revenue has not been fully exploited relative to its potential.** This can be seen from two measures. First, according to Eurostat’s calculations, the implicit tax rate on corporate profits—measured by the ratio of the total corporate tax revenue to

a proxy of the potential corporate tax base—has fallen from 32 percent in 2000 to 18 percent in 2004.



Source: Eurostat, 2007.



Source: Eurostat, 2007.

This is significantly lower than the EU-15 average (albeit higher than the NMS-10 average).<sup>23</sup>

26. **By another (imperfect) measure, the CIT base also appears to be relatively small.** The implicit base of the Greek corporate tax in 2004 was 0.09 (see table below).<sup>24</sup> This is about 20 percent lower than the EU-15 and 45 percent lower than the NMS-10. The CIT revenue as ratio to GDP in Greece declined to 3.3 percent in 2005, 2.8 percent in 2006, and is projected at 2.5 percent in 2007, tracking the fall in the corporate rate.<sup>25</sup> The implicit CIT bases are respectively 0.103 in 2005, 0.096 in 2006, and 0.10 in 2007, implying that there was no significant base broadening accompanying the rate cuts, even as the reform has abolished tax exemption on retained earnings for certain industries.

#### EU Corporate Income Tax, 2004

(Percent, unless otherwise indicated)

	Central Government Rate	Corporate Income Tax Revenue (Percent of GDP)	Implicit Corporate Income Tax Base 1/
Belgium	35.5	3.2	0.09
Czech Republic	28.0	4.8	0.17
Denmark	30.0	3.2	0.11
Germany	26.4	0.9	0.04
Estonia 2/	0.0, 35.0	1.7	0.05
Ireland	12.5	3.6	0.29
Greece	35.0	3.0	0.09
Spain	35.0	3.5	0.10
France	34.3	2.4	0.07
Italy	33.0	2.2	0.07
Cyprus	10.0, 15.0	3.7	0.25
Latvia	15.0	1.7	0.11
Lithuania	15.0	1.9	0.12
Luxembourg	22.9	5.8	0.25
Hungary	16.0	2.1	0.13
Malta	35.0	4.2	0.12
Netherlands	34.5	3.3	0.10
Austria	29.5, 34.0	2.4	0.07
Poland	19.0	2.2	0.12
Portugal	25.0	3.0	0.12
Slovenia	25.0	2.0	0.08
Slovak Republic	25.0	2.5	0.10
Finland	29.0	3.5	0.12
Sweden	28.0	3.0	0.11
United Kingdom	30.0	2.8	0.09
EU-15 (average)	...	3.1	0.11
New member states (average)	...	2.7	0.13

Sources: PriceWaterhouseCooper, *World Wide Summaries*, "Corporate Taxes," 2004–05; and Eurostat, 2007.

1/ Corporate tax revenue as a percent of GDP, divided by the highest tax corporate income tax rate.

2/ For Estonia, the zero central government rate applies to undistributed profits. Distributed profits are subject to a tax rate of 26/74 (about 35 percent).

<sup>23</sup> Eurostat data are only available up to 2004 for most countries; each country's potential corporate tax base is calculated from the production and income accounts of their own national accounts.

<sup>24</sup> The implicit base is calculated by dividing the CIT revenue as a ratios to GDP by the rate of the tax. For countries with more than one CIT rate, the highest rate is used in the denominator. For these countries, the implicit base shows a less favorable picture than in reality because it does not recognize the part of the base that is subject to a lower tax rate.

<sup>25</sup> This includes revenue from the CIT and those classified under "special categories".

## Taxable Base

**Expanding the corporate tax base will help preserve corporate tax revenue as ratio to GDP.** With increased international capital mobility, pressures toward lowering the statutory corporate rate will likely continue in the absence of an international co-operative framework against tax competition. For Greece—as in other countries—preserving the share of corporate taxes may require an expansion of the corporate tax base. By law, the CIT is levied on the net taxable income from *all* sources of a business entity. The law recognizes five categories of taxable income (immovable property, movable property, business income, agriculture income, and income from other sources).<sup>26</sup> The net result of each income category is calculated separately, and then aggregated to determine an enterprise's total net taxable income. In general, the law permits loss offset from one source against another.<sup>27</sup> Losses can be carried forward for up to 5 years. Resident companies are subject to the CIT on their worldwide income, with relief given unilaterally or by treaty provision for foreign taxes paid. Companies can choose between FIFO (first-in first-out) and LIFO (last-in first out) for inventory valuation and between a straight-line method and a declining balance method for depreciation charges on plant, machinery, and equipment (at reasonable rates). While many of the above features are standard for a corporate tax, there are, however, elements of the Greek CIT that are particularly harmful for the base. These include special regimes, exempt income, generous deductions, nonstandard treatment of capital gains and valuation, and widespread tax incentives. Greece should consider reining in these areas to broaden the CIT base:

- **Special regimes.** There are two special regimes for companies outside the CIT.<sup>28</sup> First, profits from shipping operations are subject to a *tonnage tax* in lieu of the CIT. This is essentially a presumptive tax under which ships fall into one of two categories based on type and gross tonnage.<sup>29</sup> While tax competition implies that the taxation of

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<sup>26</sup> As noted, Greece applies a dividend exemption system that ensures that corporate dividends are taxed only once at the corporate level. Dividends distributed to shareholders escape tax, regardless of whether they are individuals or legal entities.

<sup>27</sup> The exception is for losses incurred in special regimes (see below), which cannot be offset against other sources.

<sup>28</sup> Financial companies such as *portfolio investment companies* and *mutual funds* are taxed at 10 percent of the intervention interest rate set by ECB, plus up to 1 percentage point above. This is final tax for both companies and investors, while *venture capital* companies are taxed at 20 percent if profits are distributed. Technically, they would also qualify as a special regime. However, the taxation of financial companies is a specialized subject that renders direct comparison with nonfinancial companies inappropriate.

<sup>29</sup> Under the first category (cargo vessels and tankers over 3,000 tons and passenger ships, floating drills over 5,000 tons and oil rigs over 15,000 tons), the tax liability depends on the age of vessel, registered tonnage, and gross tonnage. Under the second category (all other ships not classified in the first category), the tax is calculated by multiplying the registered tons by a fixed amount (in euros) that varies according to the registered tonnage.

international shipping cannot be set independently, the argument does not extend to domestic cruises and ferries, which are taxed preferentially under the tonnage tax.<sup>30</sup> To ensure that revenue forgone is kept low, Greece could consider a more regular review of the tonnage tax rates, which are set to increase by 4 percent per year during 2006-2010 (over the previous year's tax). In addition, Greece could consider subjecting domestic cruises and ferries that do not face international tax competition to the CIT. Second, there is also a form of *presumptive tax for construction companies* that do not keep proper books or are deemed to maintain inadequate or inaccurate records. Such companies are taxed on their gross income increased by 100 percent, and to which a tax rate of between 15-25 percent is applied depending on the nature of the project. Greece could consider abolishing this special tax by requiring all construction companies to keep proper books of accounts.

- **Exempt income.** Tax exemption is provided to various activities. For example, income from property in general and land rental income of religious institutions, organizations and foundations are either exempt from tax, or taxed at a flat rate of 4 percent. Also tax free are income derived by agriculture cooperatives, from gains from sales of building and land by building cooperatives, income exempt from taxation by contract ratified by law, gains from mutual funds held by companies, interests earned by the National Mortgage Bank from loans to the State (under certain conditions). Reining in these exempt activities would be helpful for base broadening and promoting fairness.
- **Deductions.** Under the law, deductions are allowed if accounts are kept in accordance to established accounting standards. To prevent abuse a ministerial decision is issued yearly listing deductible expenses, although this is not treated as an exhaustive list. Nevertheless, several deductions would appear nonstandard and generous. Greece could consider taking steps to rein them in to expand the base after a careful study (see Appendix II).
- **Gains and loss valuation.** Under the law, capital gains are treated as ordinary income, but realized gains can escape tax if they are transferred to a special reserve account (which can be used to offset future losses). This is a liberal treatment that defers taxation, which can severely narrow the base. In addition, capital losses from the revaluation of shares and bonds can be transferred to a reserve to be set off against future gains from the sales of shares. While quarantining capital losses to offset against future capital gains is common, permitting offset for (unrealized) revaluation loss is not. In addition, the law requires shares, bonds, and other securities listed in the Athens Stock Exchange to be revalued (annually) at the lower of the acquisition

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<sup>30</sup> Profits distributed from shipping operations are not subject to tax under the PIT, like dividends distribution from nonshipping operations.

cost and the current price. This, effectively, ensures that at best there would be no gains from revaluation, and if market conditions deteriorate, result in revaluation losses. Because such unrealized losses can be offset against deferred realized gains in the special loss/reserve provision account, it creates a mechanism for tax planning that effectively erodes the CIT base.

- Tax incentives.** To encourage investments, qualified businesses can choose between tax and nontax incentives, provided under Law 3299/2004, as modified by Law 3522/2006. The law offers capital aid grant, wage subsidy for new employment, and leasing subsidy. In lieu of these nontax incentives, however, qualified businesses may opt for tax incentives providing income tax exemption of 50 percent, 60 percent, or 100 percent of the acquisition cost of investment asset. The exemption is non-wastable, in that unused tax allowance can be carried forward for 10 years. The tax incentives are available for a broad swath of activities classified along two axes. First, by business type: primary (including animal farms, fisheries, greenhouses); secondary (including manufacturing, energy); and tertiary sectors (tourism). Second, by geographic locations, under which regions in the country are designated as zone A, B, or C. All qualified investments in Zones B and C receive a 100-percent tax exemption, while those in Zone A get an exemption of 50 percent for Category I investment and 60 percent for Category II investment.<sup>31</sup> The dangers of tax incentives are well documented.<sup>32</sup> In general, they are costly, provide scope for abuse, lack transparency, and may be ineffective relative to other measures. In Greece, the tax incentives, at least on paper, appear targeted. However, in practice, proper enforcement can be difficult, especially since any investment plan that encompasses establishment, expansion, and modernization would qualify. The definition for investment is extremely broad, which together with the wide coverage under the law—in terms of both sectors and location—provides considerable scope for abuse. Beyond the incentives in Law 3299/2004, other tax incentives include: in mass media, publishing businesses in newspapers and magazines can deduct 2 percent of earnings tax free; and TV and radio business 1 percent of earnings tax free (up to EUR 8,804,109) and 0.5 percent for the excess. In construction, a special law grants constructing companies exemption from capital duty (1 percent) and stamp duties (2.4 percent), and allows them to follow special depreciation rules. In offshore engineering and civil construction, full tax exemption are available for companies

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<sup>31</sup> According to the law, Category I includes electricity, tanneries, ski resorts, golf courses, 2-star hotels, tourism centers, logistics, packing, storage infrastructure, transportation, supply chain services, broadband telecommunication, software developments, research laboratories, advanced technology services, environment friendly technology, renewable energy, new products of highly developed technology, innovative products, parks, automation, arts, crafts, etc. Category II includes mining, minerals, agriculture, energy, biofuels, desalination, standardization products, tourist products, highway projects, art and craft centers, recovery and rehabilitation centers, 3-star hotels and above, etc.

<sup>32</sup> See, for example, Zee, Ley, and Stotsky (2002).

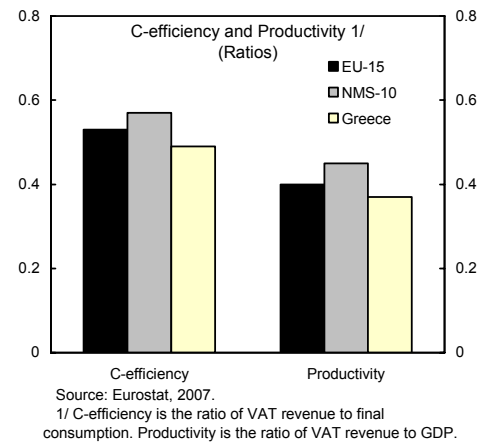
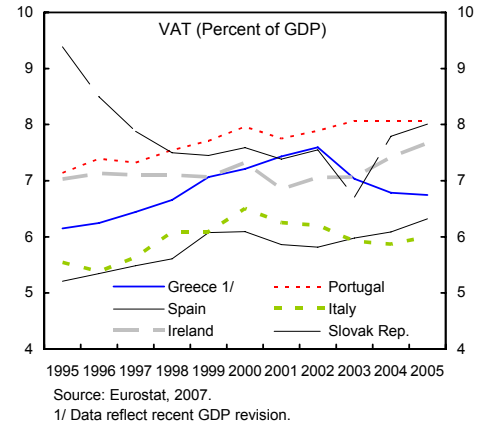
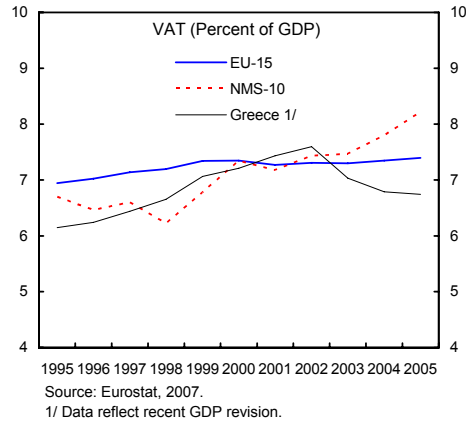
employing 80 percent of Greek nationals and importing at least US\$50,000 annually. In the Aegean Islands, the CIT rate is reduced by 40 percent for resident companies operating in islands with fewer than 3,100 inhabitants.

### E. Value Added Tax

27. **The value added tax is the most important tax in Greece, with broadly comparable performance to other EU countries.** The VAT averaged

6.9 percent of GDP during 1995-2005, broadly comparable to the EU-15 average (7.2 percent) and the NMS-10 average (7.1 percent). The C-efficiency<sup>33</sup> and the productivity<sup>34</sup> of the VAT in Greece are lower than the EU-15 average and the NMS-10 average.<sup>35</sup>

28. **Strengthening the basic design will increase the robustness of the Greek VAT.** VAT revenue climbed from 6.1 percent of GDP in the mid 1990s to a peak of 7.6 percent in 2002 and then fell to 6¾ percent in 2005.<sup>36</sup> This decline, however, reversed in 2006, due to a rate increase of one-percentage point, extension of the VAT to housing construction and stepped-up audits. While recent gains are a good sign, much more can be done to strengthen the VAT, which compares particularly unfavorably against modern VATs outside the EU (such as the New Zealand VAT, which has a C-



<sup>33</sup> C-efficiency is defined as the ratio of the VAT revenue to final consumption for each percentage point of the standard VAT rate.

<sup>34</sup> Productivity is defined as the ratio of VAT revenue to GDP for each percentage point of the standard VAT rate.

<sup>35</sup> Under an "idealized" VAT the C-efficiency would be 100 percent. Final consumption comprises private and government consumption, the latter is included because government spending on goods and services is not exempt from the VAT.

<sup>36</sup> On an accrual basis from data published by Eurostat 2007.

efficiency 0.94 and revenue productivity 0.72). Thus, further base broadening, building on recent measures to shore up VAT, revenue will make the VAT more robust.

EU VAT Revenue Productivity

	Standard VAT Rate	Other Positive Rate	Total VAT Revenue		Revenue Productivity		Year
	(Percent)		(Percent of final consumption)	(Percent of GDP)	Based on final consumption	Based on GDP	
Austria	20.0	10.0, 12.0, 16.0	10.7	7.9	0.53	0.40	2005
Belgium	21.0	6.0, 12.0	9.4	7.1	0.45	0.34	2004
Cyprus	15.0	5.0, 8.0	11.9	9.8	0.79	0.65	2005
Czech Republic	19.0	5.0	10.1	7.3	0.53	0.39	2005
Denmark	25.0	...	13.5	10.0	0.54	0.40	2005
Estonia	18.0	5.0	12.4	8.5	0.69	0.47	2005
Finland	22.0	8.0, 17.0	11.8	8.8	0.54	0.40	2005
France	19.6	2.1, 5.5	9.4	7.6	0.48	0.39	2005
Germany	16.0	7.0	8.0	6.2	0.50	0.39	2005
Greece	18.0	4.0, 8.0	10.1	6.7	0.49	0.37	2005
Greece	19.0	4.5, 9.0	...	7.0	...	0.37	2006
Hungary	20.0	5.0, 15.0	13.0	10.2	0.65	0.51	2005
Ireland	21.0	4.8, 10.0, 13.5	12.2	7.4	0.58	0.35	2004
Italy	20.0	4.0, 10.0	7.6	6.0	0.38	0.30	2005
Latvia	18.0	5.0	9.5	7.6	0.53	0.42	2005
Lithuania	18.0	5.0, 9.0	8.6	7.1	0.48	0.39	2005
Luxembourg	15.0	3.0, 6.0, 12.0	10.7	6.0	0.71	0.40	2005
Malta	18.0	5.0	8.7	7.4	0.48	0.41	2004
Netherlands	19.0	6.0	10.5	7.7	0.55	0.40	2005
Poland	22.0	3.0, 7.0	9.5	8.1	0.43	0.37	2005
Portugal	21.0	5.0, 12.0	9.6	8.5	0.46	0.40	2003
Slovak Republic	19.0	...	10.4	8.1	0.55	0.42	2005
Slovenia	20.0	8.5	12.4	9.3	0.62	0.46	2005
Spain	16.0	4.0, 7.0	8.4	6.3	0.52	0.40	2005
Sweden	25.0	6.0, 12.0	12.5	9.4	0.50	0.38	2005
United Kingdom	17.5	5.0	12.3	10.8	0.71	0.62	2005
EU-15 (average)	19.7	...	10.5	7.8	0.53	0.40	2005
New member states (average)	18.7	...	10.6	8.3	0.57	0.45	2005
New Zealand	12.5	...	11.7	8.9	0.94	0.72	2005

Sources: IMF, Country Documents; IMF, *Government Finance Statistics*; IMF, *World Economic Outlook*; OECD, *Revenue Statistics Database*; OECD, *National Accounts Database*; International Bureau of Fiscal Documentation, *Taxation and Investment in Central and East European Countries*; PriceWaterhouseCooper, *Worldwide Summaries, "Corporate Taxes,"* 2004–05; and IMF staff estimates.

## Strengthening the VAT

### 29. The VAT is in line with the provisions of the EU Sixth Council Directive.

However, with decades of design improvement from experiences gained across the world, a modern VAT today has evolved to be quite different from the VAT in most EU countries, including Greece. In brief, best practice calls for a single VAT rate on the broadest possible base, limiting exemptions to hard to tax sectors (such as financial services), and a reasonably high taxable threshold. Thus, Greek VAT can become more efficient if the following weaknesses are addressed: (1) multiple rates should preferably be reduced to a single rate (or at most two); (2) numerous goods and services currently taxed at reduced rates should be subject to the standard rate; (3) nonstandard exemptions should be eliminated (or greatly reduced), and (4) low VAT thresholds should be raised.

- **Multiple rates.** Introduced in 1987, the VAT has six positive rates (exports are zero rated). The standard rate has been increased twice, from 16 percent initially to 18 percent in 1998, and subsequently, to 19 percent in 2006, where it now remains. Reflecting the policy that reduced rates may be necessary to achieve various social

goals and promote equity, the VAT has a 9 percent reduced rate on a wide selection of goods and services, and a 4.5 percent super-reduced rate on books, magazines, and newspapers. In addition, to promote regional development, there are three additional rates—at 30 percent below the standard, reduced, and super-reduced rates (respectively, 13 percent, 6 percent, and 3 percent)—that apply to taxable transactions in certain geographical areas.<sup>37</sup> The large number of rates makes Greece an outlier (out of 144 countries with a VAT today, more than one half have a single-rate VAT).<sup>38</sup> The government could consider other policy tools for achieving objectives sought under multiple rates. A multiple-rate VAT increases administrative and compliance costs, lends opportunity for misclassification and abuse, and can lead to an increase in the number of taxpayers in excess credit position. Against these disadvantages, two considerations are often put forward to support a multiple-rate VAT. First, from an efficiency standpoint, one may wish to tax different consumption types at different rates—depending largely on their elasticity. However, given its multistage nature, the VAT is ill equipped to deal effectively with this, as multiple rates can impose large compliance and administrative costs. Excises, another form of consumption tax, can often be more effective.<sup>39</sup> Second, from a redistributive perspective, one may wish to tax those goods consumed by the poor at lower rates. This argument, however, is weakened in the presence of other policy instruments. Where available, as in Greece, the personal income tax is often a more effective tax instrument for achieving any given redistributive goal. In addition, cash transfers can also be more efficient for pursuing equity goals compared to differential VAT rates.

- **Reduced rate taxation.** The list of goods and services subject to reduced rate is particularly long. Currently, the 9 percent reduced rate and, its counterpart, the 6 percent reduced rate for certain geographical areas, apply to a wide selection of goods and services, including in food, agriculture, medical, transportation, housing, hotel and restaurant services, utilities, repairs, culture, sports, and other services. If Greece wishes to raise revenue productivity, it could consider curtailing the list of goods and services subject to reduced rate taxation. Under a modern VAT, most, if not all, goods and services are subject to the standard rate. A careful look at the rationale for taxing goods at a reduced rate—in particular, by comparing the cost and benefit of using reduced rate taxation with other instruments that could deliver the same objective—would likely lead to a sharply shortened list. However, if Greece

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<sup>37</sup> For example, in the islands of the prefectures of Dodecanese, Chios, Cyclades, Lesvos, Samos, the Aegean islands of Thasos, Samothraki, Skyros and Northern Sporades.

<sup>38</sup> In the modern VAT era, based on a 2001 survey, 53 percent of the VAT systems in the world have a single rate VAT, another 23 percent have two rates, 13 percent have three rates, 9 percent have four rates; and Greece, a distinct outlier, has six rates.

<sup>39</sup> See chapter 7 in Ebrill and others (2001).



wishes to keep a reduced rate for equity reasons, it would be best to limit it to a few selected, unprocessed food items widely consumed by the poor.

- Nonstandard exemptions.** A VAT exemption occurs when output is untaxed and input tax is not recoverable. It is an aberration in the logic of the VAT and poses difficult issues for VAT design. In Greece, VAT exemptions comprise the standard, noncontroversial sorts (such as public sector, financial, medical and education services).<sup>40</sup> However, there are also nonstandard ones, including: goods and services related to social welfare of children and young people; first homes; water; postal services; radio and TV services; pharmaceutical; insurance and reinsurance services; certain fund raising events; and gaming and lotteries. To improve the VAT design and revenue, Greece may wish to consider abolishing nonstandard exemptions. In general, exemptions can give rise to an uncertain revenue impact, which could increase or decrease, depending on the stage on which the exemption is levied. Since the VAT exempts many services at the point immediately prior to final sale (such as first home, children goods, pharmaceutical, gaming and lotteries), this lowers revenue as the final stage escapes tax. Thus, bringing them into tax will increase revenue. On the other hand, the revenue impact of removing VAT exemption on items which are both intermediate and final goods (such as postal and insurance services, and water) is less clear, since exempting intermediate goods actually increases VAT revenue while exempting at the final stage loses revenue. More generally, reducing exemptions can improve the design of the VAT by limiting distortions over input choices and eliminating the incentive to self-supply.<sup>41</sup>
- VAT thresholds.** Exemptions, when judiciously adopted, have a place in the design of a VAT. For instance, in addition to the standard exemptions (financial services and public sector services), exemptions for hard to tax sectors—such as small traders and farms, where high administrative and compliance costs can make their inclusion into the VAT net non effective. The VAT thresholds in Greece are particularly low—EUR 10,000 (for goods) and EUR 5,000 (for services)—placing a legal requirement on virtually all businesses to register. Yet, it is clear that many do not. It therefore makes sense to consider increasing the thresholds substantially so that administrative resources can be more effectively employed (businesses with low turnover produce little tax) while small businesses not registered for the VAT are in compliance with the law.

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<sup>40</sup> When output is sold at prices below their market value, commonly relating to goods provided by the public sector such as the provision of education and health, such services are traditionally exempt (private provision of similar services are taxed). That said, arguments have been advanced for taxing public sector education and health services, which is the case in the New Zealand VAT.

<sup>41</sup> See Chapter 8 in Ebrill and others (2001).

## F. Excises

30. **Greece has one of the lowest excise collections in the EU, reflecting low excises on energy products.** Greece has harmonized its excise system with EU legislation, levying excises on alcoholic beverages, energy products and electricity, and manufactured tobacco in accordance with EU rules. Excise revenue is low, in particular, from energy taxation (1.2 percent of GDP in 2005 or about 60 percent of the EU-25 average).<sup>42</sup> In part, this is because for certain products (such as leaded and unleaded petrol and gasoil), Greece has a transition regime that will remain in place until 2009.<sup>43</sup> In part, the low yield is due to fraud induced by the high rate differentials in gasoil taxation—for instance, gasoil for heating is taxed at EUR 21 per 1,000 liters but the same product for propellant in 2007 was taxed at EUR 276 per 1,000 liters.<sup>44</sup> To combat excise fraud in gasoil, the authorities have recently restructured the taxation of gasoil by harmonizing the two rates in 2008 at EUR 293 per 1,000 liters.

31. **Further scope may exist for increasing excise rates for selected energy products.** Excises on energy products, including gasoil, are still low, and will continue to be low even after 2009 when Greece is expected to exit from the transition excise regime. Increasing excises on selected energy products (in particular, for petrol and gasoil) beyond the EU minimums—in a judicious manner, taking into account the concern of cross-border transactions, legal or otherwise—would help raise excise collection as a share of GDP. In addition, it might also give rise to a “double dividends”. Not only will higher excise on energy products benefit the environment, by strengthening public finances they may also permit a reduction in the reliance of more distortionary taxes.

## G. Property Taxation

32. **Property taxes are underexploited in Greece.** Like most countries, Greece levies several taxes on property, including the following:

- a state property tax on large property;<sup>45</sup>
- a capital gains tax;<sup>46</sup>

<sup>42</sup> See, Eurostat (2007), Table C.4.1\_G: Environmental Taxes as Percent of GDP: Energy.

<sup>43</sup> Excises on leaded petroleum will increase from EUR 384 per 1,000 liters in 2007 to EUR 409 in 2008, and to EUR 421 (the EU minimum) in 2009. For unleaded petroleum, the excise will increase from EUR 331 per 1,000 liters in 2007 to EUR 338 in 2008, and EUR 359 (the EU minimum) in 2009. Gas oil rate will increase from EUR 276 per 1,000 liters to EUR 293 in 2008, and EUR 302 (the EU minimum) in 2009.

<sup>44</sup> These rates are in place over the winter period, October-April.

<sup>45</sup> This is a narrow base property tax, known by its Greek acronym *FMAP*. A property tax on smaller property was eliminated earlier.

<sup>46</sup> Known by its Greek acronym *FAY*, this is a variable rate tax depending on holding period; see Table 2 for the tax rates.

- a transfer tax;<sup>47</sup>
- a transaction duty;<sup>48</sup>
- a surtax on rental income from land and building;<sup>49</sup>
- a revaluation surplus tax;<sup>50</sup>
- a special tax;<sup>51</sup> and
- a local property tax.<sup>52</sup>

33. **Greece could consider placing greater reliance on property tax and less on transaction-based taxes on property.** The latter generates more revenue in Greece (0.4 percent of GDP compared with 0.1 percent of GDP from property tax *per se*), but they are less efficient and, whenever possible, should be used sparingly. For instance, the transfer tax and the transfer duty are cascading taxes, which reduce property transactions. High transaction taxes can also discourage registration, which could undermine the functioning of the property tax. Similar arguments can be made for income-based taxes on property. For example, the revaluation surplus tax—a nondeductible expense for enterprises holding properties—increases the cost of doing business and may distort property ownership, especially by businesses. In addition, the surtax on personal income and the special tax on corporate income generated from property treat income derived from property investment less favorably than other sources of income, they lower the attraction in property investment. By contrast, a property tax levied on a building and land is a highly efficient tax as the base is fixed. When properly designed, it can also yield considerable revenue.<sup>53</sup>

34. **Recognizing the need for rationalization, Greece introduced a new property tax in 2008, but the reform efforts could go even deeper.** The new tax will replace the *FMAP* expanding the property tax base to include residential and commercial properties, and zoned land. The tax rates are set at 0.1 percent for individual’s properties and 0.6 percent for legal

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<sup>47</sup> This is levied on the resale of building constructed before 2006 and on land at rates of 7 and 9 percent. First homes are exempt. Buildings constructed after 2006, which are subject to the VAT, is not subject to this tax.

<sup>48</sup> This is a one percent tax, payable by the buyer, levied on the value of real property transactions. First homes are exempt.

<sup>49</sup> Payable as a surtax under the PIT, the rate is 1.5 percent.

<sup>50</sup> The revaluation surplus tax has two rates: 2 percent for land and 8 percent for building based on some notion of “objective value” set by the authorities. The surplus tax is not deductible under the CIT.

<sup>51</sup> The special tax rate is 3 percent on gross income from immovable property payable under the CIT. Exemptions are widely available for this tax.

<sup>52</sup> Unlike the *FMAP*, which is a state level tax, this is subnational level tax on property at fairly low rates set by individual jurisdictions. It is known by the Greek acronym *TAP*.

<sup>53</sup> For instance, according to an unpublished IMF data, the average property tax collection from a group of 16 OECD was 1.4 percent of GDP in the 1990s, and Poland collects about 1 percent of GDP in property tax.

entities' properties. However, the tax will exempt first homes (below 200 square meters and valued at less than Euro 300,000) and rural properties. The tax is expected to yield about 0.3 percent of GDP on a *net* basis. The introduction of the new property tax is a step in the right direction, most significantly by broadening the tax base. However, Greece could consider doing more to strengthen the new property tax. For instance, consideration could be given to: (1) broadening the base more by further narrowing exemptions (including first homes and bringing rural properties into tax); (2) adopting a market-based valuation to replace the notional "objective value"; (3) unifying the tax rates on residential and business buildings to limit opportunities for evasion;<sup>54</sup> and (4) moving quickly to set up a national registry for buildings (and land) for proper monitoring. In addition, beyond the property tax, it seems that a further streamlining of other taxes on property would be beneficial, including transfer taxes and duty, revaluation surplus tax, surtax on rental income, and the transaction duty.

## H. Concluding Remarks

### 35. The broad tentative conclusions of this chapter are as follows:

- *The PIT could be strengthened by expanding its base and through better control over evasion.* In particular, tax administration should be improved to ensure that the self-employed and those in the informal sector pay a fair share of the tax would support this goal.
- *The CIT revenue could be preserved by narrowing incentives and deductions.* In the long term, tax competition and pressures to cut statutory rates imply that for Greece the task is more likely to be about protecting corporate tax revenue rather than increasing it as a share of GDP.
- *Social taxes could be protected by broadening the base to the informal sector and reducing evasion.* Because of significant underfunding of the public pension system, Greece probably would not be able to consider reducing social taxes despite their high rates in the absence of a fundamental pension reform.
- *The VAT could be strengthened* by reducing the number of rates and shifting most goods and services currently taxed at reduced rates to the standard rate, and raising its thresholds.

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<sup>54</sup> This will eliminate issues of misclassification and limit opportunity for evasion in cases where a building can serve as both a home and a place of work.

- *Selective excises could be increased*, specially where collection as a share of GDP has been declining steadily over time. In particular, consideration could be given to raising rates on energy products to raise the budgetary contribution of environmental taxation.
- *Property taxes could be raised* by, for example, expanding the base further and moving to market based assessment, while streamlining a host of myriad taxes still levied on property, including the high transfer tax.

36. **In addition, Greece could consider the benefit of introducing a tax expenditure budget** in order to make transparent the revenue cost of preferential tax treatments, distortionary exemptions, and incentives when using the tax system to pursue certain social objectives.

## **Appendix I. Personal Income Tax: Nonstandard Tax Credit and Deductions**

The **nonstandard deductions** include:

- insurance premiums (for life, death, personal injury and sickness) for self, spouse, and dependent children (capped at 10 percent of the tax-exempt income bracket);
- investment in mutual funds (up to euro 3,000 or 20 percent of investment);
- donations (to state, religious institutions, nonprofit organizations, and approved sport clubs);
- relocation allowance up to euro 3,600 (for taxpayers outside Attica and Thessalonki, up to five years and if the taxpayers are under 40 years of age); and
- special deduction beginning in 2008 of up to euro 8,000 to encourage taxpayers to collect invoices and receipts from purchases.

The **nonstandard-tax credits** include:

- 20 percent of annual rent for main residence;
- 20 percent of annual rent of school boarding for dependent children;
- 20 percent of tuition expenditure (capped at euro 240);
- 20 percent of interest mortgage payment for loans for principal home not exceeding euro 200,000 (with certain conditions on home size);
- up to euro 3,000 for alimony payment;
- up to euro 700 for natural gas installation system;
- up to euro 6,000 for medical expenses for self and dependents; and
- up to euro 60 tax credit for each child for taxpayers with employment income living for at least 9 months in certain border areas or islands.

## Appendix II. Proposals for Reining in Corporate Income Tax Deductions

37. **Certain employees' remuneration are deductible** (such as payment for kindergartens for their children and cash prized up to EUR 3,000 per employee for achievements during their studies in universities).
38. **There is no thin-capitalization rule to prevent abuse of interest expense in the tax law.**<sup>55</sup> Greece could study the option of disallowing interest deduction for firms with excessively high debt-equity ratio.
39. **The CIT provides additional R&D allowance (up to 50 percent when such expenses exceed the average of previous two years).** This allowance could be open to abuse since R&D expenses are difficult to monitor. It is often also unclear where the market failure lies, if Greece wishes to support R&D with public funds, it could consider funding research activities in institutes of higher learning as an alternative.
40. **Capital recovery in the CIT could be simplified. The CIT has a reasonable capital recovery system, with a straight-line or declining balance depreciation method.** However, there are over a dozen asset classes.<sup>56</sup> Greece could study the benefit of simplifying the depreciation method. In addition, depreciation rules favor new businesses. Start-ups can choose not to take depreciation charges in the first 3 years, or depreciate them at half the ordinary rates. Allowing new businesses, which are more likely to be in a tax loss position, the option to defer depreciation or take it at a reduced rate narrows the future CIT base.
41. **Under the law, a financial leasing company (lessor) is permitted to take depreciation charges, while the lessee can amortize the lease payment.** This is contrary to best practice, which lets the lessee take the depreciation charges in order to limit the opportunity for tax planning and avoidance by leasing companies.<sup>57</sup>
42. **Subject to limits, donations to sports clubs and cultural sponsorship are tax deductible.** These deductions are unusual in that they almost always have no relation to the production of income

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<sup>55</sup> Under the company law, a legal entity with a debt-equity ratio below 50 percent is required to convene a shareholder's meeting to decide to take action (or not). By law, the entity must be liquidated if the debt-equity ratio falls below 10 percent.

<sup>56</sup> Depreciation rates are adjusted from time to time, the current set was introduced in 2003. Assets under EUR 1,200 may be expensed in the year of acquisition.

<sup>57</sup> For financial leases, the lessor (who provides a loan to the lessee to finance the purchase of the underlying capital asset) is treated essentially as a financial company. Under best practice, the lessor is subject to tax on the lease income and is not permitted any depreciation expenses on the leased equipment. The lessee takes the depreciation on the capital asset, deducts the interest expense from the loan, and creates an equivalent liability of the loan equal in value to the acquired capital asset in its balance sheet.

43. **Nonfinancial businesses<sup>58</sup> may deduct 0.5 percent of turnover (limited to 30 percent of trade receivables).** While prudential consideration calls for loan loss provisioning (often restricted to financial companies), revenue considerations often argue for limiting such provisions (indeed, solely to financial companies). The bad debt provision for nonfinancial entities is against the tax principle not to provide for uncertain future events, but recognizing losses when they accrue.

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<sup>58</sup> This is also available to partnerships, which equally reduces the base of the PIT.



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