Dóra Győrffy

*Catching up in the wake of the crisis?**

The quality of fiscal policy and economic growth

With a view to its economic policy during the 2007–2009 financial crisis, Hungary – for the first time in many years – has been one of the most disciplined countries. In this context, the author seeks to find out whether this relative improvement in fiscal policymaking is sufficient to lay the foundation for future convergence and whether it contributes to putting Hungary's economy on a track of sustainable growth. In answering this question, the study first reviews the literature of theories regarding correlations between the quality of fiscal policy and economic growth, highlighting six impact mechanisms. Then the interrelations of mechanisms between fiscal policy and growth and their impact on real economy processes are presented using the experiences of Portugal, where – due to euro-area membership – the central budget plays an especially important role in fostering economic growth and adaption to various shocks. The main conclusion of this paper is that the mere quantitative change of fiscal policy elements cannot yield lasting results unless the quality of fiscal institutions is improved as well.

Contrary to the deficit spending of recent years, Hungary became one of the model countries of fiscal discipline during the financial crisis. The 7.7 percentage point restriction in 2008–2010 which has focused primarily on expenditures is actually the second strictest austerity package in all OECD countries. The only place where an even greater correction is planned is Ireland where an 8.3 per cent restriction is envisaged, principally due to tax raises (OECD, 2009a, page 64). As a result of these steps, Hungary's budget deficit and government debt will be significantly below both the OECD and the euro-area averages. What is even more important, however, is that according to an OECD forecast, Hungary will be the only country besides Norway out of the organisation's 30 member countries where no further restrictions will be needed in 2010–2017 (OECD, 2009a, page 231).

The progress in establishing fiscal discipline is not invalidated by the fact that this correction was obviously undertaken under compelling force. Due to the deficit spending in

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former periods, Hungary was one of the first countries cut off from foreign funding opportunities upon the breakout of the financial crisis. As a precondition to accessing the joint bridging loan of the International Monetary Fund, the European Union and the World Bank, the Hungarian government was forced to take measures that would have been politically unbearable just a few months earlier.[1] As alternative financing channels were missing, any plan to reduce the depth of the recession by stimulating demand with fiscal means was illusory.[2]

The current consequence of restrictive measures carried out during the crisis is the deep setback which is expected to exceed 6 per cent in 2009 when this manuscript was closed. Regarding the future, however, both the government and analysts (in Hungary and abroad) expect these measures to boost GDP growth and Hungary's competitiveness once the crisis is over.[3] Another benefit of these steps is that they may bring Hungary closer to Euro-area accession by restoring budget equilibrium. Finally, it may be particularly important for the future that the painful experience of the crisis and the correction steps made both politicians and citizens aware of how severe the consequences of undisciplined fiscal policy can be.[4]

Amidst the general optimism that surrounds the crisis, however, it is necessary to ask the question whether the fiscal policy measures taken so far are sufficient to ensure sustainable economic growth. In other words, does the restoration of equilibrium in itself lead to growth? Although this has been one of the evergreen topics of Hungarian economic policy in recent decades, it will be even more significant in the future: with the giving up of monetary policy upon accession to the Euro area, fiscal policy will be the only remaining means for the government to influence economic trends. Therefore, it is of particular importance that fiscal policy is turned into an effective tool for managing the challenges deriving from monetary union membership before accession already.

To answer this question, first I briefly overview the literature of interrelations between fiscal policy and economic growth, focusing on six impact mechanisms. Then using Portugal as an example I present the relations between the various mechanisms and their real-life manifestation after Euro-area accession. The main conclusion of my study is that the impact of fiscal policy on economic growth cannot be limited to equilibrium at all and that the negligence of other qualitative considerations may become a barrier to sustainable growth and may lead to the reproduction of disequilibria sooner or later. What it means is that stabilisation that focuses merely on equilibrium considerations is not sufficient and changes that ensure high quality and efficient public services in the long run are indispensable for economic convergence.

FISCAL POLICY AND ECONOMIC GROWTH IN THEORY

When discussing the relationship between fiscal policy and growth, the first thing is to point out that economic policy cannot determine directly the growth rate of a country's economy (Erdős, 2003, page 15). However, it does not mean that economic policy cannot have a role in economic growth, as in an indirect manner it can play an important role in shaping the factors that determine a country's growth potential. According to the endogenous theory of economic growth (Romer, 1986; Lucas, 1988; Barro, 1991), it is the productivity improvement of human and physical capital as enabled by technological development that brings on per capita GDP growth and prevents the decrease of the marginal productivity of capital to zero.[5] Based on this theory, the indi-

rect impact of economic policy can take effect in two ways. First, it can influence, but not determine, the quantity of growth resources (labour, human and physical capital). Second, it can impact the efficiency of their utilisation. Below I apply the classification used in a study by *Barrios* and *Schaechter* (2008) to present briefly[6] the mechanisms through which the various qualitative dimensions of fiscal policy can indirectly impact growth drivers. When discussing the specific mechanisms, I always address how the crisis calls for the refinement of the presented theoretical considerations.

The size of the state

One element of the relationship between fiscal policy and economic growth which has received the most attention in recent decades is the size of government redistribution. According to the critics of large government, excessive fiscal redistribution may reduce economic growth through the following mechanisms (Tanzi, 2005).

❶ By providing public services (e.g. free education, healthcare, mandatory pension insurance), the state reduces the pressure on citizens for self-care and thereby decreases their willingness to save. Without savings, investment funding opportunities shrink.

❷ Revenues that finance government spending distort economic decisions and taxation may discourage employment and investments.

❸ Government expenditures crowd out similar private sector expenditures. If we accept that competition makes the private sector more efficient, the increase of redistribution by the state conveys efficiency losses.

Naturally, the arguments listed here do not mean to suggest that there is no need for a state at all, as there are a number of duties which the private sector is unable to perform: Defence, legislation, law enforcement (safety of private property) or the guaranteeing of the efficient operation of markets. The representatives of institutional economics confirmed by way of theoretical and empirical studies that good institutions reduce transaction costs in the economy by protecting private property and the freedom of contracting and thereby they make the redistribution of resources more efficient (North, 1995). What is more, institutional quality is not simply one of many factors. Instead, as pointed out by *Rodrik, Suramanian* and *Trebbi* (2004) or *Acemoglu, Johnson* and *Robinson* (2005) among others, it is the number one variable that explains economic development. If we accept these findings, it is also obvious that the state is definitely needed for sustaining a quality institution system and that it must take resources from the private sector to finance the fulfilment of its responsibilities. It is important to underline that as the private sector and the public sector share the labour supply of a country, these drained resources may be substantial, since the public sector can only attract trained and motivated workforce if it offers compensation that is competitive with comparable private sector offerings.

Therefore, the correlation between the size of the state and growth is presumably not linear but rather resembles a "U" turned upside down: by fulfilling certain duties, the state may actively contribute to the increase of economic efficiency, while above a certain level of redistribution, wastage and the discouraging effects listed above become dominant. If we accept that the correlation between the size of the state and growth resembles an upside down "U", the main question is the whereabouts of the threshold beyond which counter-effects come into play. Empirical literature does not provide a satisfactory answer to this question.[7] Furthermore, the level of development, historical traditions and openness among others obviously play also a decisive role in setting the optimal redistribution level for a country.[8]

Therefore, only rules of thumb can be set. As for Barrios and Schaechter (2008, page 12), the optimal size of the state is around 35 per cent for small and open economies and around 40 per cent for large countries. *Tanzi* (2005) put the desirable rate of government redistribution to an even lower level, about 30 per cent. Having analyzed the effectiveness of public spending in emerging economies, a study by *Afonso, Schuknecht* and *Tanzi* (2006) confirmed the same figure.

Developed countries reached these levels by the 1970s already,[9] i.e. since then the decrease of economic freedom and the resulting counter-effects dominated over the potential positive aspects of a large state. It is not only coincidence that studies examining developed EU and OECD countries using time series that begin in the 1970s almost without exception found a significant negative correlation between the size of the state and growth and the findings stood testing against a number of factors.[10] The same is evidenced indirectly by a study of Schuknecht and Tanzi (2005), presenting convincing arguments that on nearly every scale (fiscal and economic performance, human development, institutional quality), reform-focused EU 15 countries that have decreased fiscal redistribution significantly definitely outperform countries that have not changed the size of the state. The slight negative impact in income redistribution is offset by better economic performance, decreasing unemployment and more focused social expenditures. A case study by *Hauptmeier, Heipertz* and *Schuknecht* (2006) on eight countries showed similar results. That study used the examples of Ireland, Spain and Sweden to demonstrate that countries which carried out radical reforms through a program of reducing transfers, subsidies and community consumption had much better equilibrium and economic indicators than countries which only touched expenditures cautiously.

The apparently unambigous results may be altered by the crisis somewhat as a larger state enables the more powerful operation of so-called automatic stabilisers[11] and thereby it can dampen the setback. It is not by coincidence that during the 2007–2009 financial crisis, a negative correlation could be observed between the size of the state and that of the required stimulus packages (OECD, 2009b, pp. 117–118). While this finding does not invalidate the counter-motivation effects of extensive redistribution, it may supply another argument for the upside-down "U" correlation between size and growth – i.e. the purpose of economic policy cannot be simplified to the dogmatic approach of "the smaller the state, the better it is" which neglects qualitative and sustainability considerations.

Sustainable budget position

Once the financial crisis passes, budget sustainability is expected to be in the focus of discussions on fiscal policy and growth issues.[12] Although like with the size of the state and growth, empirical literature did not come to clear-cut conclusions regarding the correlation between budget sustainability and growth[13] either, theoretical literature suggests that lasting budget disequilibria and large government debt may have a negative impact on growth through a number of mechanisms.

❶ General government deficit and a high debt rate force companies out from the loan market as it is always less risky to lend money to the state than to companies (Chalk and Tanzi, 2002, page 187). What is more, increased demand for savings drives interest rates upwards which also make corporate investments more expensive.[14]

❷ According to the Ricardian equivalence (Barro, 1979), a high government debt leads to anticipations of high future taxes which

changes profit expectations and thereby decreases investments.

❸ Disequilibria and high indebtedness narrows elbow room for anti-cyclical fiscal policy, i.e. it exposes the country to inevitable restriction in times of recession which thereby undergoes bigger fluctuations.[15] The reason of procyclicality is that loan resources usually shrink during setbacks and lowering confidence in budget sustainability immediately triggers a high interest premium which can undermine the potential positive impact of a budgetary expansion. (Spilimbergo at al, 2008, pp. 7–8).

❹ Measures taken to correct disequilibria can be damaging for growth on their own. Increased inflation reduces dependability in the economy while the increase of revenues (due to increased government redistribution) may result in the counter-motivation effects described above.[16]

❺ Disequilibria are typically accompanied by greater fiscal policy swings which also have a negative impact on growth as the decreased calculability of the economy affects both propensity of saving and investment decisions. *Fatas* and Mihov (2003) presented this correlation based on findings that involved 91 countries. *Afonso* and *Furceri* (2008) came to a similar conclusion based on the experiences of the EU-15.

It is important to note that while these findings seem to be overlooked especially in developed countries during the crisis for the sake of recession-mitigating efforts, this does not mean that underlying theoretical considerations are challenged. Writings that propose temporary loosening of the budget regularly mention the inevitable need for correction in the medium run (Spilimbergo et al, 2008; Cottarelli and Vinals, 2009; OECD, 2009b, pp. 105–134).[17] In summary, even if differences of opinion[18] may exist regarding desirable fiscal policy during the crisis, they do not impact the consensus on the importance of long-term sustainability. In this respect, theoretical considerations need even less adjustment than in conjunction with the size of the state.

Composition and effectiveness of public spending

Beyond the size of the state and sustainability, the composition of expenditures is another consideration that received intense attention recently. *Barro* (1990) was the first to differentiate productive and non-productive expenditures based on whether a government expenditure directly contributes to output growth in the private sector. As per the theoretical definition, productive expenditures usually include investments in education, research and development and infrastructure while non-productive expenditures include social transfers. The latter not only fail to contribute to growth, but they may be counter-motivating for employment and have negative growth impact through the decrease of labour supply. Results of empirical literature support these considerations significantly (Kneller et al, 1999; Romero de Ávila and Strauch, 2003; Afonso and Allegre, 2008).

Besides the differentiation between productive and non-productive expenditures, another vital aspect of the correlation between government spending and growth is the effectiveness of productive expenditures. In empirical literature, this issue receives particular attention in conjunction with government investments. Findings on the growth impact of these investments are rather controversial, sometimes even the same author comes to different conclusions based on different samples. While based on the examination of the EU-27 countries the study by Afonso and *Allegre* (2008) found that public investments stimulate private investment and growth, Afonso and Furceri (2008) did not find any significant correlation between public expenditure and growth in OECD countries.[19] The extension of the analysis to the developing

world may shed light to these controversial results: as pointed out by Tanzi and *Davoodi* (1997), countries with widespread corruption have a higher rate of public investments but the effectiveness of those projects is lower. Therefore, it is not sufficient to differentiate simply between productive and non-productive expenditures. The efficiency of public spending is also a vital issue.

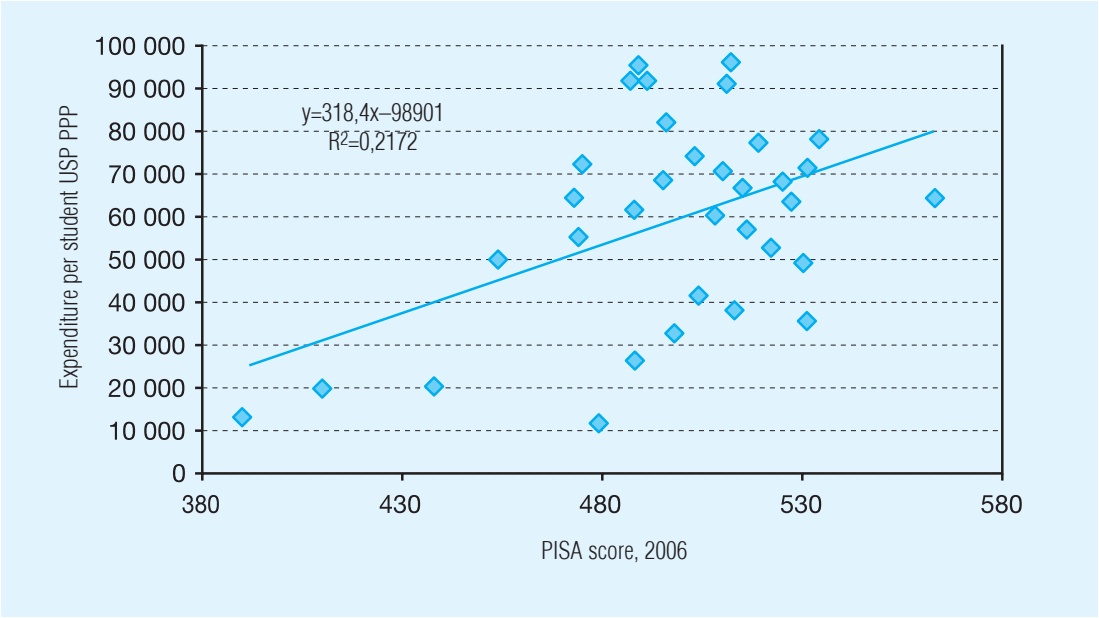
The measurement of the effectiveness of public spending received increased attention from economists in recent years. Examining the experiences of emerging countries, Afonso, Schuknecht and Tanzi (2006) confirmed the assumption that the efficiency of the public sector varies significantly by country. This is well visible in education where only a weak correlation exists between expenditures and effectiveness *(see Chart 1)*.

Needless to say, few doubt the importance of the efficient utilisation of public funds. The likely reason for the many analyes that focus on the extent of expenditures is more the fact that the measurement of public spending is far from being a clear-cut exercise with commonly accepted standards. One common statement in studies on the subject is that neither effectiveness nor any of its components can be quantified entirely (Mandl et al, 2008).[20]

However, even though effectiveness considerations might be overlooked somewhat in econometrical analyses due to the difficulties of measuring, it is not a valid reason for neglecting quality aspects when making economic policy decisions. After the financial crisis, the composition of budget expenditures and the related quality considerations are likely to become more important as the purpose and effectiveness of available public funds will be critical as funding options are narrowing. Therefore, theory does not need adjustments in this area, but a shift of emphasis is expected in analyses from a purely quantitative approach to increased consideration of qualitative criteria.

Chart 1

GOVERNMENT EXPENDITURE PER STUDENT AND SCORE ON THE PISA SCIENCE COMPETENCE TEST IN OECD COUNTRIES, 2006



Source: OECD, 2008a, page 307

Structure and effectiveness of the income side

Besides the composition and effectiveness of expenditures, another similarly important growth factor is the way of financing the state, i.e. the structrue of the income side. The already quoted study by Barro (1990) differentiates between taxes that distort investment decisions and taxes that do not, is it is important to fund government expenditures with the lowest possible distortion. Consequently, preference is given to tax systems that lean towards consumption taxes versus labour, corporate and property tax. The first reason is that consumption taxes rely on a broader base than other tax types. The second reason is that these taxes are not levied on contribution to the economy but rather on actual consumption and thus they do not have a counter-motivating impact. Another important consideration is that consumption taxes are far more difficult to evade than taxes on capital gains and corporate profits. High taxes on labour, however, in particular excessive progressivity, have a negative effect not only on employment but also on investment into human capital, as they narrow the wage premium associated with education. From this viewpoint, the position of secondary earners on the labour market is especially important. While the labour supply of primary earners responds less elastically, the willingness to work of other members of the household depend greatly on the tax system (Barrios and Schaechter, 2008, page 22).[21]

Similarly to the previous parts, empirical results regarding taxation and growth performance are less clear than theoretical considerations. Concerning tax wedge and employment, statistical results are far from being significant and many countries have a high employment rate and a high tax wedge at the same time (Lackó, 2009, pp. 528–529). Although several studies mention that high taxes on labour and high social security payments have a negative effect on growth (Kneller et al, 1999; Afonso et al, 2005; Afonso and Allegre, 2008), different methods and different samples may lead to the opposite conclusion: Afonso and Furceri (2008) point out the negative growth impact of indirect taxes in EU-15 countries.

Similarly to the previous topics, the contradictions of empirical results regarding the correlation between growth and the structure of the tax system highlight two findings: First, growth cannot be examined on the basis of a single factor. Second, like with public expenditures, effectiveness considerations may play a significant role on the income side as well. Today, besides the actual tax rates, the administrative burdens on taxation also receive special attention in the various competitiveness rankings. This administrative burden is largely dependent on the transparency and stability of the tax system (World Bank, 2008). An effective tax regime enables the payment of taxes at low cost and its stability ensures the calculability of the economic environment. Both are important considerations in investment decisions and thereby impact growth performance as well. As shown in *Chart 2,* the tax wedge and tax administration burdens practically do not correlate at all, thus a high tax rate in itself does not explain high admanistrative burdens. What it means is that the decrease of revenues (and the size of the state simultanously to that) is not necessarily the only possible way of improving competitiveness. Significant progress can be achived by ensuring effectiveness and calculability as well.

Like with the previous topics discussed herein, the correlations identified between the income side of the budget and growth are not voided by the experiences gained during the crisis. If the international community indeed takes more powerful steps against tax havens than before, it can even facilitate tax collection and limit tax competition. Nevertheless, as the

shrinking of resources is likely to result in fiercer competition among countries, the importance of quality aspects will definitely grow in the exploitation of growth potential.

Fiscal institutions and growth

The role of fiscal institutions received increased attention in recent years in conjunction with macroeconomic discipline. Since the 1992 study of *Von Hagen*, several research efforts dealt with the correlation between fiscal rules and fiscal performance. In this context fiscal institutions mean quantitative limits, procedural rules (budgeting, approval and implementation phases), transparency rules and independent institutions. The primary role of these institutions during the budget process is to reduce the participants' opportunities to pursue policies that serve individual or partial interests as such opportunities emerge due to the complexity of the process and the limited nature of information. E.g. politicians tend to use the budget for retaining power which creates political business cycles, while various pressure groups strive for maximising their share from and minimising their contribution to budget resources. Rules serve to narrow the elbow room for such endeavours and thereby reduce the propensity of democracies to spend[23].

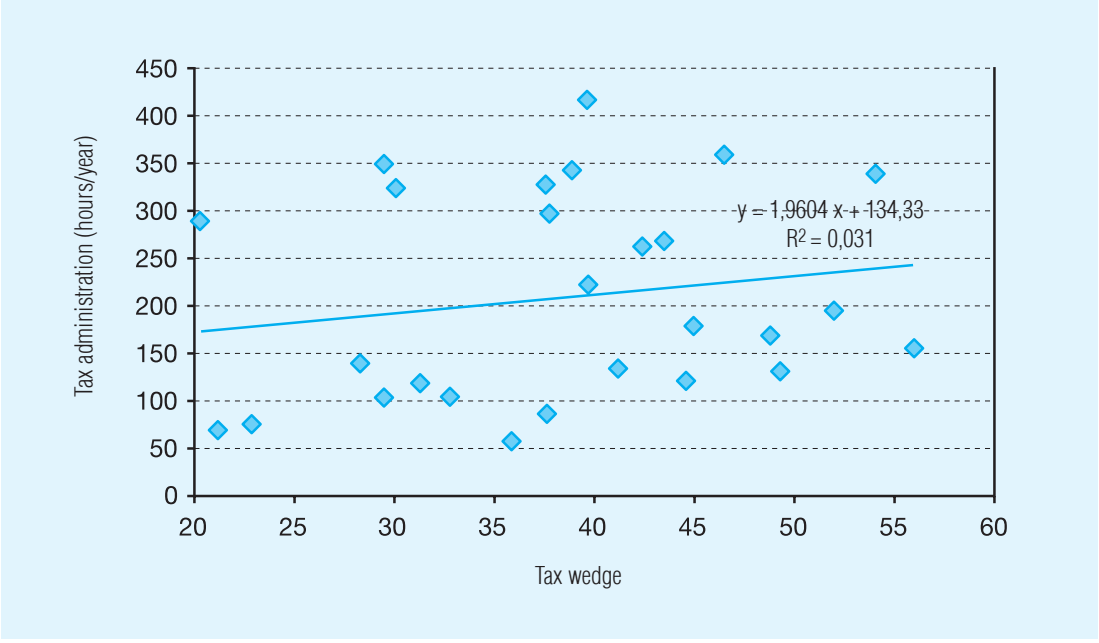
The growth effect of these rules are indirect and relates principally to the factors listed earlier. Based on already mentioned literature sources, key impact mechanisms are as follows.

❶ By taming the propensity of democracies to overspend, rules reduce the formation of disequilibria which have a negative growth impact.

❷ Rules regarding budget expenditures (budget ceiling laws) prevent the increase of the state which could also have a negative effect on growth.

Chart 2

TAX WEDGE[22] AND TAX ADMINISTRATION IN OECD COUNTRIES, 2008



Source: OECD, 2008b és World Bank, 2008, pp. 53–55

❸ Rules on budgeting and transparency can also help the effectiveness of expenditures and incomes by e.g. stictly requiring impact studies or a financial plan with a several years outlook.

❹ Budget transparency can be an especially important element of reinforcing trust in the government. First, it can increase the willingness to pay taxes (Scholtz és Lubell, 1998). Second, it enables perspectivic decision-making that focuses on long-term considerations and it reduces the temptation of populism for politicians (Győrffy, 2007b). While the first factor has a favourable growth impact through a broader tax base and the resulting lower taxes, the latter increases the effectiveness of both the expenditure and income side.

The significance of a credible institution system is expected to grow after the financial crisis. Concerning the handling of disequlibria generated by efforts to manage the crisis, nearly all researchers underline the importance of reinforcing fiscal rules and procedures (Spilimbergo et al, 2008, pp. 8–9; Cottarelli and Vinals, 2009, page 13; Lane, 2009, page 248). For a stricter institution system guarantees to investors that fiscal disequilibria are not originating in pressure group-driven policymaking and that budget sustainability will not be at risk once the situation is back to normal. If this message is credible, the government may have far more room for handling the cyclical fluctuations of the economy than with the financial markets suspecting political motivations behind every fiscal loosening.

Fiscal policy and business environment

A relatively rarely mentioned but rather important area of the correlation of fiscal policy and growth is the impact on the business environment. International competitiveness rankings put a great emphasis on the time and money requirement of setting up a business and obtaining the necessary licenses which may affect investor decisions. Although these administrational reforms do not cost much and may offer great benefits according to the World Bank (World Bank, 2005, page 7), the difficulties of implementing them show well that these reforms may hurt many interests. *Török* (2007, page 1072) points out that whenever the budget is in need of fee revenues from administrative procedures, the chances of simplification are scarce. Bureaucracy may also be counter-motivated in a similar manner, as endeavours to bypass the complex and expensive rules offer vast room for corruption. The ineffective regulatory environment can exercise a negative growth impact through a number of mechanisms (Erdős, 2003, pp. 123–125).

❶ Expenses on administration, be they in the form of fees or corruption, increase the cost of investments and make investors look for alternative locations for their businesses.

❷ Complex regulations which trigger corruption and the change of rules reduce the calculability of the economy, make business cost benefit calculations difficult and thereby reduce the level of investments.

❸ Decreasing investments as described in point 1–2 narrow employment opportunities.[24] First, it means unused resources, and second, it means a shrinking tax base and the need for a higher tax wedge. We discussed the negative growth impact of the latter earlier.

❹ Complex and expensive regulations spur corruption which distorts market competition and thereby results in lower economic productivity.

Chart 3 confirms the points presented above. It is apparent that the ratio of administrative expenses to the GDP varies significantly between 1.5 and 7 per cent across European Union member states. It is also clear that as described in relevant theories, a close negative

correlation exists between administrative expenses and perceived corruption.

Like with the previous criteria, the financial crisis does not call for the revision of theoretical considerations in this area either. Although cross-border financial transactions are likely to be bound by stricter rules, business founding and licensing costs in individual countries and administrative burdens of taxation (which are important for the players of the real economy) are likely to be significant competitiveness factors in a time when global competition is fiercer due to lack of funding.

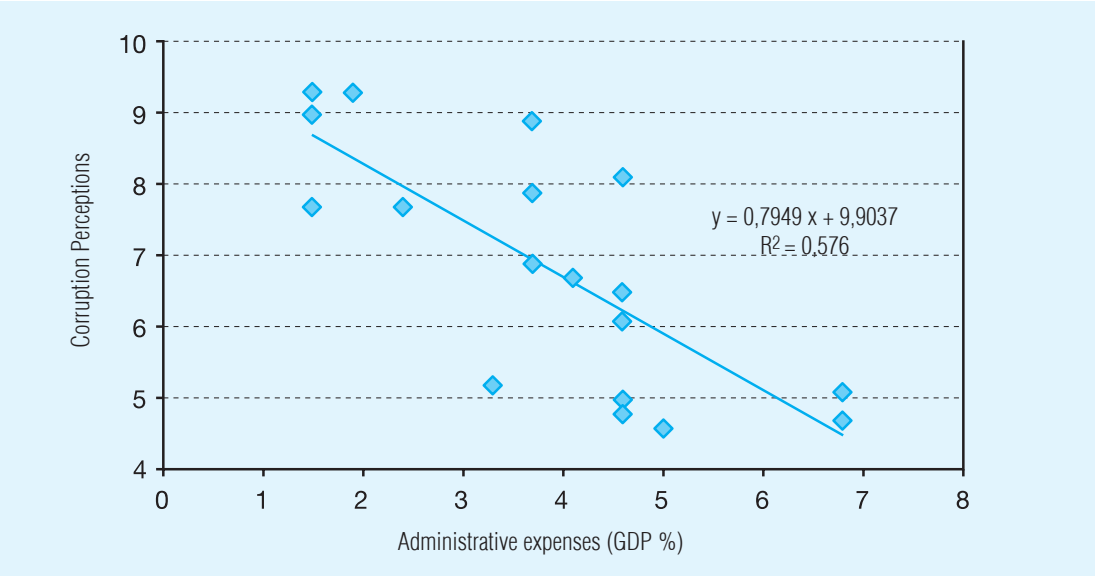
Fiscal policy and growth in theory: summary

Having reviewed the correlations between the quality of fiscal policy and growth, the single most important conclusion is that the various impact mechanisms are closely interrelated and are hardly separable. The key linchpin is institutional quality in a broad sense, i.e. the efficiency of public administration which simultaneously impacts the size of the state, the effectiveness of public spending, the payment of taxes and the business environment. As it turned out in previous sections, these considerations are not only left unchallenged[26] by the crisis, but their significance is expected to grow thereafter as competition for investments will intensify due to decreasing liquidity on capital markets.

With the recognition of the pivotal role of institutions in the relationship between fiscal policy and growth, the six mechanisms described herein can also be summarized with the analogy of angelic and diabolic circles. A well-functioning public administration ensures the dependability of the legal environment and the effective provision of public goods, creating a good environment for investments and maintaining a high level of employment. This guarantees a wide tax base and thereby the efficient financing of the public sector with an acceptable tax wedge. Contrary to this, corrupt public administration is unable to provide for

Chart 3

ADMINISTRATION EXPENSES AND CORRUPTION IN THE EUROPEAN UNION, 2006



Source: European Commission, 2006, page 3 and Transparency International, 2006[25]

public services efficiently which means an unfavourable environment for investments and spurs tax evasion. The resulting proliferation of the black economy distorts market competition and calls for a higher tax wedge for decent taxpayers which has a negative impact on growth.

If we accept the metaphor of angelic and diabolic circles and the fact that correlations are extremely complex, it also becomes clear why the conclusions in empirical literature are not identical regarding the growth impact of specific indicators – be it the size of the state, public spending or the distribution of various tax types. The reason is that numeric indicators are unable to capture the underlying effectiveness and the interworkings of various factors in any of these areas although they are decisive regarding the growth impact. In order to understand the dynamics of the complex interrelations described above, it is better to look at a case study instead of analysing static indicators to see how the various mechanisms take effect in practice. Below I analyse the experiences gained in Portugal, a country that failed to converge to the EU average in the past ten years despite their accession to the euro-area. The quality of fiscal policy played a vital role in this (under)performance and thus Portugal may provide a number of important lessons to both theoretical approaches and Hungary.

Fiscal policy and growth in practice: the case of Portugal

As mentioned in the introduction, the correlation between the quality of fiscal policy and growth is especially significant in the monetary union where monetary policy tools are unavailable for managing various economic difficulties. I.e. during a crisis there is no way to reduce interest rates or improve competitiveness[27] by decreasing relative wages costs through inflation or the devaluation of the domestic currency. Without the availability of monetary policy tools, fiscal policy plays an especially important role and the mechanisms listed in the previous section may be critical regarding the economy's ability to adapt to shocks.

The example of Portugal may serve as a good illustration for the impact mechanisms of fiscal policy, for although the country joined the Euro-area in 1999, the convergence envisaged by inflation theory failed to happen and Portugal stagnated at around 75 per cent of the EU average in the past decade. What also contributed to this poor performance was that Portugal slid into a deep recession in the early 2000s and got on a slow growth track afterwards *(see Chart 4)*. Even though that recession was negligible compared to the depth of the current crisis, lastingly slow growth is an even graver problem than a big, one-time setback. Furthermore, the adaption mechanisms provided by fiscal policy are not different in these two cases either. Below we will look at how the poor effectiveness of Portugal's fiscal institutions prevented the country's adaption to external shocks and thereby its growth in the past decade. First I will provide a brief review of the period of growth and recession and then outline in detail the role of fiscal policy in this performance.

Overheating and setback at the turn of the millennium

Portugal joined the European Community in 1986 and began to grow dynamically from then on. Far exceeding the average of other EU countries, its growth rate was over 4 per cent in each year during 1986–1991 (European Commission, 2008, page 48). Albeit the ERM crisis also hit Portugal severely in 1992, apart from the 2 per cent setback in that year, the country grew above the average rate in all

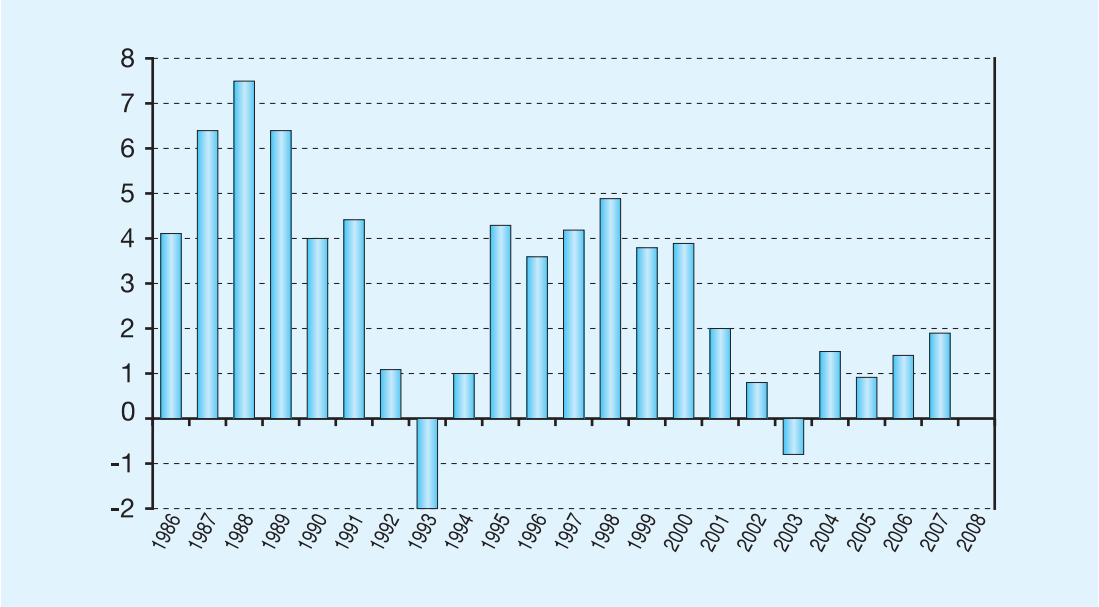
other years of the decade. As shown in Chart 4, this period ended after the launch of the euro and after a brief period of recession, the country's economy grew at 1 per cent for years.

The starting point of growth problems was financial liberalisation. The financial sector which used to be mostly in government ownership in the 1970s was liberalised in the 1990s in conjunction with EU integration, i.e. banks were privatised, and barriers to the cross-border flow of capital were abolished along with various interest rate regulations.[28] The main threat conveyed by liberalization is usually the possible formation of a credit bubble and then a financial crisis. What it means is that due to the growing availability of resources, lending expands considerably which overheats the economy. It generates a high growth rate in the beginning which is then followed by a significant setback. This is clearly perceivable in conjunction with the 2007–2009 crisis. Still, as a study by *Kaminsky* and *Reinhart* (1999) outlined, this is one of the key common roots of various financial crisis types.[29]

Although initially in Portugal it seemed that credit growth impacted households only and there is no bubble (IMF, 1998), by the 2000s it became apparent that a bubble took shape – like in other countries. The underlying reasons were numerous. In the early 1990s, extremely high interest rates and a strong domestic currency were needed to decrease inflation which was about 10 per cent at the time. After 1993, however, higher credibility resulting from ERM membership and the Maastricht convergence process triggered a decrease of interest rates (Constancio, 2005, page 208). On top of that, liberalisation generated fiercer competition and made foreign resources accessible. As a result, long-term interest rates dropped from 1990's 15.4 percent to 4.9 per cent in by 1998 (Európean Commission, 2008, page 126). Due to easier access to funding, both household and corporate indebtedness expanded significantly *(see Chart 5)*.

Chart 4

GDP GROWTH IN PORTUGAL, 1986–2008



Source: European Commission, 2008, page 48 and Eurostat[30]

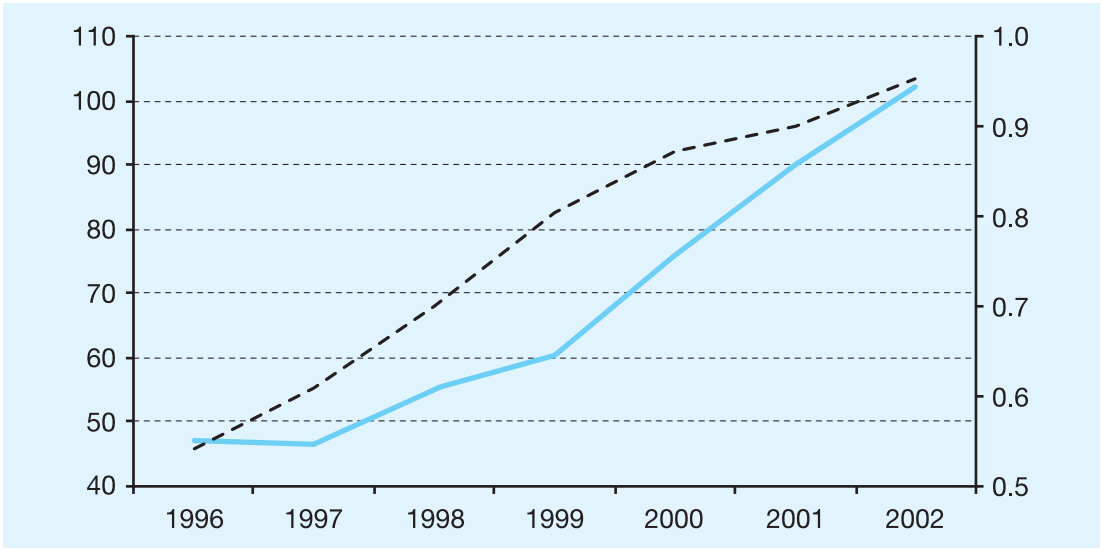
The phenomenon that took shape in Portugal[31] as a consequence of this development was way too familiar from the literature of former financial crises. A significant portion of additional funds flowed to the real estate sector or financed consumption (IMF, 2000, pp. 25–27). First it generated considerable growth (Chart 4) and was accompanied by the decrease of unemployment from the 1996 level of 7.2 per cent to 4 per cent (European Commission, 2008, page 34). The shrinking of the labour market triggered a salary increase that surpassed the growth rate of productivity, leading to decreased competitiveness and deteriorating current account figures. Overviews of these trends are provided in *Charts 6 and 7.*

The decrease of productivity became truly apparent when the bursting of the technology bubble and the 2001 terror attacks triggered a setback in the global economy, resulting in a significant decrease of demand for Portugal exports *(see Chart 8)*. The increase of domestic demand could not offset the significant drop of exports, as the formerly developed indebtedness of the private sector could not be augmented any further and as the budget deficit which Portugal failed to reduce sufficiently during the boom years had to be settled during the recession due to pressure from the EU (we will discuss it in more detail in the next chapter).

As shown in Chart 8, not only the growth of exports decreased but also Portugal's share in the aggregate exports of the EU-25. This is a clear indication that the underlying trends not only included the global setback but the significant deterioration of competitiveness as well. The combined effect of these processes was reflected in the lower growth rate (Chart 4). In 2006 and 2007, economic growth accelerated somewhat but still failed to reach 2 per cent. As the detailed analysis of data revealed, this improvement did not originate in structural factors but in the temporary increase of demand in Portugal's main export destination markets (IMF, 2007a, page 5). However, the global economic crisis halted this process as

Chart 5

HOUSEHOLD AND CORPORATE INDEBTEDNESS IN PORTUGAL



Remark: for households *(continuous line),* the left scale shows the debt rate as a percentage of disposable income while for businesses *(dotted line),* the right scale shows the debt vs. shares.

Source: IMF, 2004b, page 4

well and according to a Eurostat forecast, following years of weak growth, Portugal will slide back into a 3.7 per cent recession in 2009.

Having discussed the growth issue of Portugal, let me return to the main question of this study, i.e. the role of fiscal policy in this entire process.

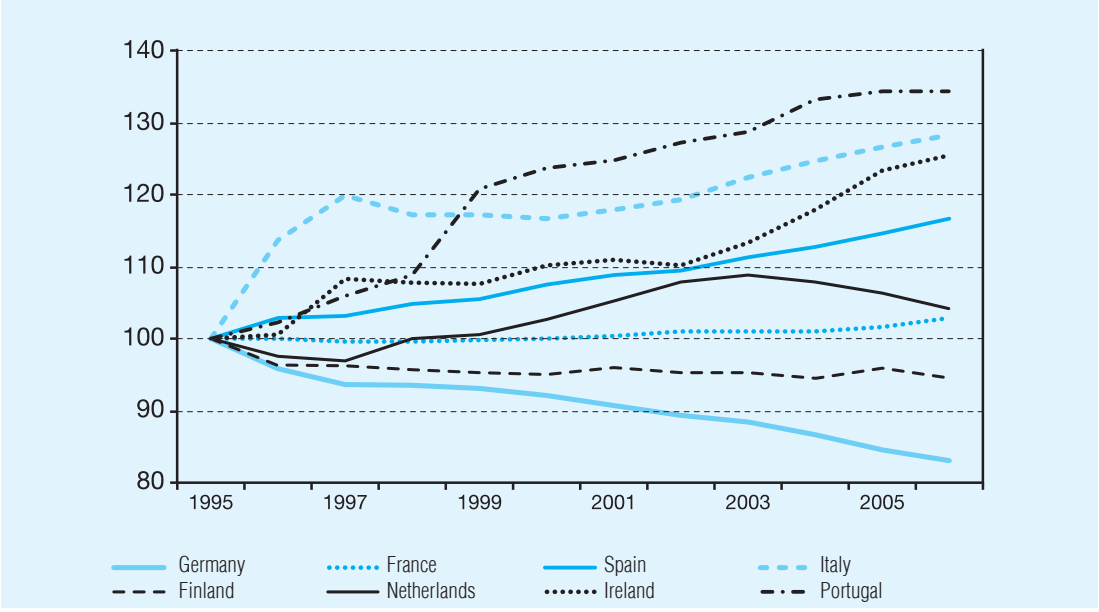
The role of fiscal policy in the difficulties of adaption

If Portugal was not a member of the European Monetary Union, the easiest way of managing the competitiveness problem caused by economic overheating would be to devaluate the domestic currency. This was the very purpose of the crawling peg devaluation applied after the 1970s which intended to offset Portugal's inflation which exceeded that of its competitors (Basto, 2007, page 12). The same approach was applied during the recession in the early 1990s, devaluating the escudo significantly in three steps between 1993 and 1995 . Naturally, devaluation is definitely not a long-term solution. This type of measures becomes part of the anticipations of market players, making it difficult to keep inflation under control and triggering speculation attacks against the domestic currency. Furthermore, disguised exports subsidies help sustain outdated economic structures. Therefore, the loss of this intervention opportunity upon euro introduction is not necessarily a problem in the long run, as without other available options it enforces structural changes and restores competitiveness. According to *Blanchard* (2006), adaptation can take place in two ways: through the decrease of wages or the increase of productivity.

Below I review the impact of Portugal's fiscal policy weaknesses (which we discussed above) on these adaption scenarios. However, first I examine the role of fiscal policy in stabilising the economic cycle which may complement or replace monetary policy to some extent and reduce the size of cyclical fluctuations.

Chart 6

UNIT LABOUR COST IN THE EURO AREA (1995=100)

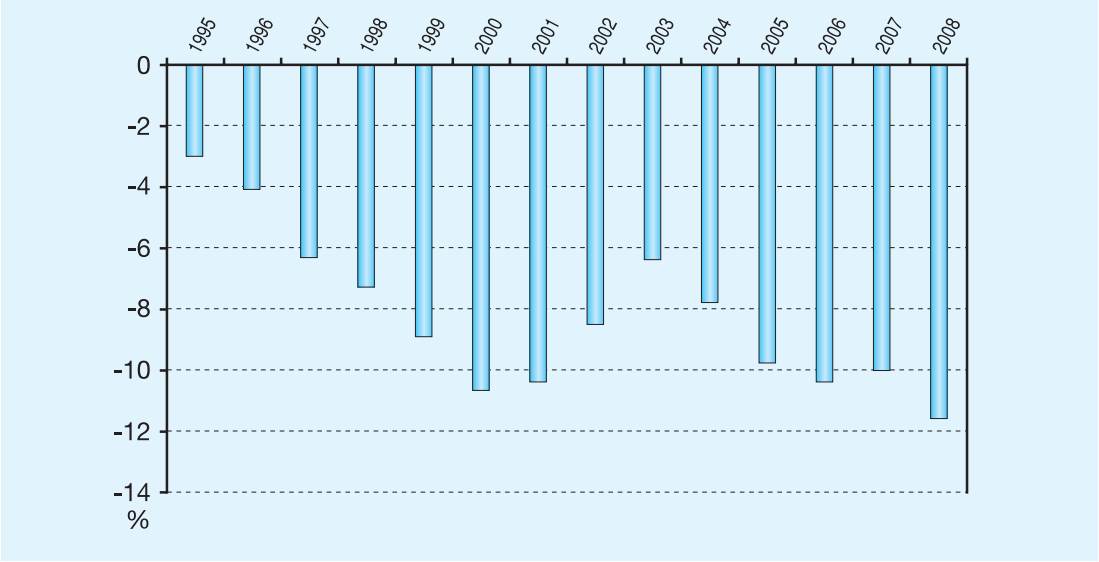


Source: IMF, 2007a, page 8

Chart 7

PORTUGAL'S CURRENT ACCOUNT BALANCE, 1995–2008

(GDP %)

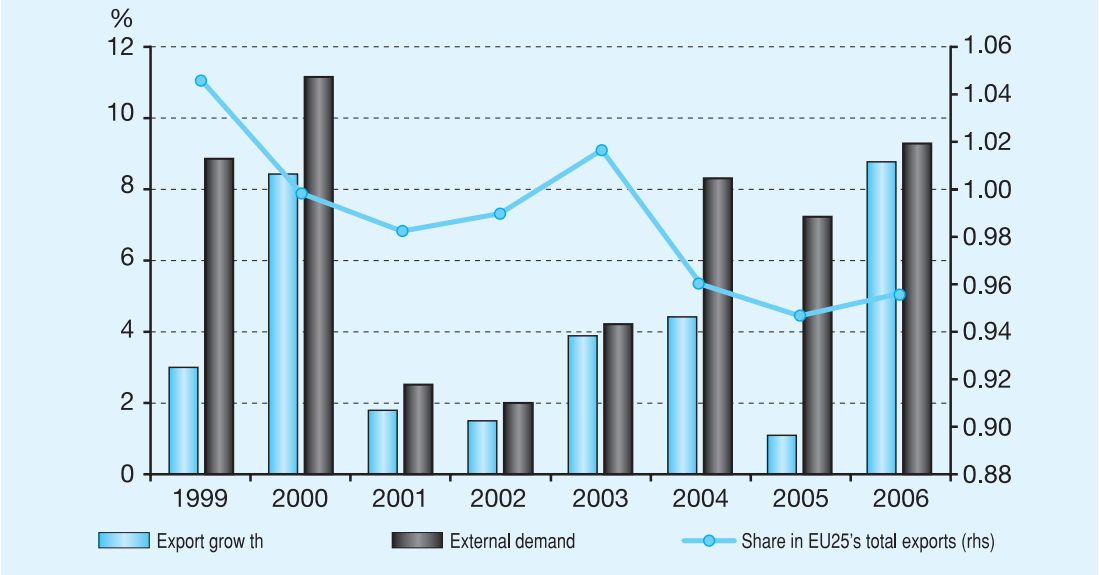


Source: European Commission, 2008, page 116

Chart 8

GROWTH OF PORTUGAL'S EXPORT AND SHARE IN EU-25 EXPORTS, 1999–2006

(%)



Source: IMF, 2007a, page 5

The elbow room of fiscal policy during recession

As mentioned earlier, under certain conditions, fiscal policy can reduce economic fluctuations through automatic stabilisers or active anti-cyclical policy pursued by the government. This way, the external demand shock in the early 2000s could have been offset theoretically by a less tight fiscal policy approach. These preconditions, however, were not fulfilled in Portugal. The reasons were as follows.

Although the size of the state is growing in Portugal, it is still among the smaller ones.[33] Consequently, automatic stabilisers do not function as extensively as in e.g. a Scandinavian country. Second, Portugal is a small open economy where a potential fiscal policy loosening can easily lead to current account deterioration and therefore budgetary expansion can only play a limited role. Besides these objective factors, however, economic policy failures also contributed significantly to the fact that fiscal policy hindered recovery from the setback instead of helping it.

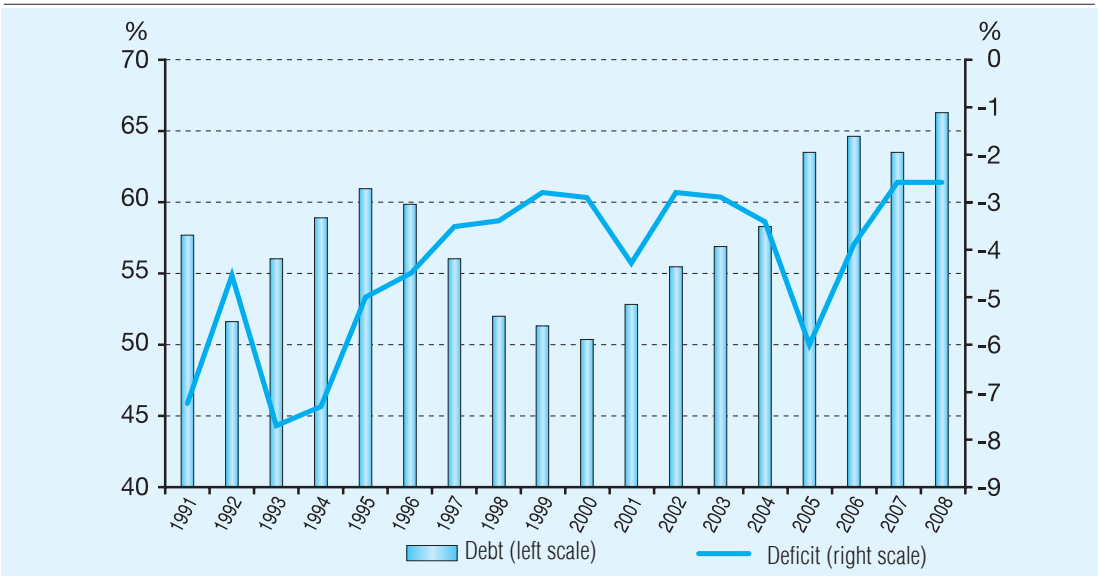
As shown in *Chart 9*, Portugal hardly fulfilled the 3 per cent budget deficit ceiling set out in the Maastricht criteria while its debt began to grow extensively from 2000 on. As an especially serious problem, the budget deficit was hardly below 3 per cent even in boom years, leaving no space for fiscal loosening at the time of recessions. As pointed out by *Constancio* (2005, page 213), savings deriving from lower interest services were not spent on balance improvement but on primary expenditures, more specifically government wages. Consequently, the budget balance had to be improved in the very course of recession in order to comply with the provisions of the Stability and Growth Pact and thus the decrease of external demand was accompanied by that of domestic demand, too.

On top of all that, the structure of correction was not optimal which also hindered the adaption of the economy. Consolidation basically consisted of four elements (IMF, 2004b, page 11): i. increase of value added tax, ii.

Chart 9

GOVERNMENT DEBT AND BUDGET DEFICIT IN PORTUGAL, 1991–2008

(GDP %)



Source: European Commission, 2009, pages 142, 154

reduction of government investments, iii. freezing of government wages, iv. one-off items. One common feature of these measures is that they are easily reversible which means they do not offer a lasting solution. What this means is that even at the time of forced corrections, the country failed to implement structural changes whereby the two other available adaption mechanisms were blocked as well. This is the topic of the next two sections.

Fiscal policy and the wage decrease option

One of the key advantages of the Euro area is that it has successfully ensured price stability since its formation, i.e. it kept inflation around 2 per cent. Although this factor can be considered a very important prerequisite of economic calculation and thus growth, one of its consequences is that inflation cannot be applied any longer to offset lower competitiveness by reducing real incomes. If prices are stable and the increase of wages exceeds that of productivity, short-term correction is only feasible through the reduction of nominal wages, for the increase of productivity requires a longer timeline as we will see in the next section.

The decrease of nominal wages usually meets tough resistance from employees, for they do not necessarily agree with the primary importance of increasing competitiveness and they tend to trust productivity growth instead. As Blanchard points out (2007, pp. 7–8), these considerations are especially valid in the case of Portugal because existing laws prohibit the decrease of wages without reason. Not only the explicit reduction of wages is excluded, but employees are protected against dismissal by the strictest rules in the EU which again narrows the elbow room of employers regarding wages policy as the threat of unemployment is limited anyway.[34] Beside the strict rules, however, special fiscal policy features also pose difficulties to wage cuts.

Earlier we discussed that government salaries went up considerably in Portugal in the 1990s. Albeit this increase was successfully put under control in the early 2000s, *Chart 10* shows that in 2005 Portugal's spend on government wages in percentage of the GDP was still by far the highest among the original 12 Euro area countries. What makes it a problem in particular is the relatively low effectiveness of public services which we will discuss later. In terms of wage reduction, high government salaries pose a problem because the country's labour supply is shared between the private and public sectors and therefore a wage cut limited to the private sector will drain quality workforce from there.

Besides high government wages, another fiscal factor is the growing level of social transfers paid in cash which also acts against the decrease of nominal wages. In percentage of the GDP, the value of these transfers grew steadily from 9.5 per cent in 1991 to 15.6 per cent in 2008 (European Commission, 2009, page 76). Benefits of this kind, e.g. high unemployment benefits cause problems because they may function as attractive alternatives to accepting a wage decrease.

Fiscal policy and the barriers to productivity growth

The third and probably most forward-looking element of adaption to recession and efforts to mitigate the decrease of competitiveness would be the improvement of productivity. In Portugal, the productivity of labour reflected a decreasing trend since the 1990s and equalled only 55 per cent of the euro area average in 2004 (IMF, 2005, page 6). One direct reason of this divergence is the slow pace of structural changes in the economy. According to *Lains* (2007), the main reason for the productivity gap between Ireland and Portugal is that industries that produce and use advanced info-communication technologies gained much less

ground in Portugal while traditional sectors (textile and shoe manufacturing) lost significant market share due to Asian competitors. As for this author, the deeper reason is that Ireland is ahead of Portugal in terms of both physical and human capital accumulation. While the improvement of these factors does not purely depend on the public sector of course, citing *McKinsey* the IMF (2006, page 4) says that roughly two thirds of the gap can be eliminated by way of public policy measures.

According to the IMF, nearly half of the deceleration of productivity derives from the lack of capital investments (2005, page 5). Nearly each qualitative dimensions of fiscal policy affect the magnitude of investments.

Investments are fundamentally affected by the dependability of the economy. As mentioned earlier, Portugal's budget balance is constantly negative which assumes a growing tax burden. Although the country's approximately 37% tax wedge is not extraordinary, growing tax burdens and poor performance regarding stability and simplicity (IMF, 2007a, page 17) definitely contribute to low investments. The causes of low productivity, however, lie deeper.

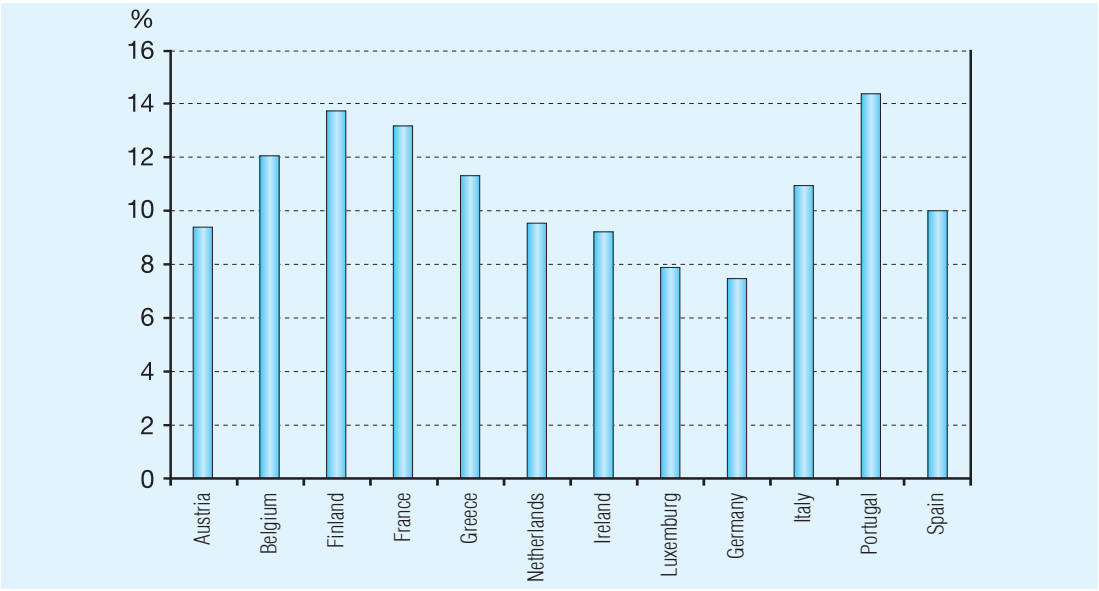
One key factor of investments, especially in high-tech sectors, is the quality of human capital which highly depends on the effectiveness of education and expenditures on research and development. Portugal underperforms developed OECD countries in both areas. Within the EU-15, Portugal is the only country that spends less than 1 per cent of the GDP on research and development and only Greece scores worse in the PISA tests that measure the effectiveness of education (IMF, 2006, page 20). These factors illustrate the importance of budget structure and that of the effective utilisation of public funds.

As pointed out by Blanchard (2007, pp. 14–15), the solution to the productivity issue is not necessarily the increase of research and development expenditures. Besides advising to ease labour market regulations e.g. in order to facilitate seasonal employment in tourism,

Chart 10

GOVERNMENT SALARIES IN THE 12 EURO-AREA MEMBER STATES

(GDP %)



Source: European Commission, 2009, pp. 58–59

Blanchard underlines the significance of the informal economy as one of the key productivity decreasing factors. What makes the informal economy an issue is that it enables small, inefficient companies to survive, making it more difficult for businesses in the formal sector to increase their market share. This way, economies of scale are not utilised sufficiently which causes problems in the construction industry in particular. Another problem is tax evasion which makes the use of labour cheaper instead of capital investments which is another productivity decreasing factor. All in all, the informal economy distorts the operation of the market selection mechanism, i.e. it reduces the pressure to improve productivity.

As discussed above, the informal economy is very closely related to the quality of fiscal policy. Excessive regulation and the resulting corruption both encourage the bypassing of laws and thus strengthen the informal economy. What is more, Portugal's poor public services are expensive as reflected by the extraordinarily high wages in the public sector (Chart 10). This leads to higher taxes than justified by the quality of services provided and therefore discourages investments.

Summary

In a monetary union, adaption to external shocks is far more difficult than outside the Euro area where cost-based productivity can be improved temporarily by devaluating the domestic currency or accelerating inflation. In order to adapt successfully to external shocks that occur time to time, a country in a monetary union must inevitably improve the quality of its fiscal policy. This compelling force in itself is an argument for joining the monetary union, for as described in the previous section, fiscal policy affects the value of growth drivers and the effectiveness of their utilization through a number of channels, either negatively or positively. However, the case of Portugal illustrates that it can take even a decade for this pressure to take effect and an ineffective fiscal system can be a substantial road block regarding adaption to external shocks in the meantime. What it means is that the improvement of credibility and the jump in growth which follows accession to the Euro area is temporary only, i.e. in itself it does not provide for the preconditions of sustainable growth.

LESSONS FOR HUNGARY

The question which served as a starting point of this paper was whether the steps taken to restore budget balance after the crisis are sufficient to set Hungary on a sustainable growth track. To answer this question, I first reviewed the correlations between fiscal policy and growth in the light of relevant theories then I used the example of Portugal to illustrate how these mechanisms work in practice. Based on the findings reviewed herein we can now provide an answer to the main question of this paper.

The answer is already evident from the theoretical review: Equilibrium and sustainability are important and necessary to ensure that fiscal policy does not become a barrier to growth, yet they are far not sufficient to make fiscal policy contribute to it. In the case of Portugal it is apparent that the most important consequence of the budget deficit (which was high even during booms) is that the government cannot pursue an anti-cyclical fiscal policy at the time of recessions. Yet qualitative fiscal weaknesses proved to be an even greater problem as they hindered the long-term adaptation of productivity and thereby fundamentally contributed to lastingly slow growth.

In summary, both theory and practice highlighted the fact that the improvement of insti-

tutional quality in a broad sense is indispensable if fiscal policy intends to actively contribute to sustainable economic growth. For this is the factor which determines whether angelic or diabolic cycles take shape in the economy and accordingly, if the economy diverges or converges. Therefore, the question is, to what extent did the recent changes help this qualitative improvement. If we look at the six dimensions that determine the quality of fiscal policy and see how they were changed in the recent past, we can put the current achievements into perspective.

◗ *Size of the state:* despite the restrictions, the size of the state not only failed to decrease but rather increased during the past years. Based on data in the review prepared in relation to the stand-by loan of the International Monetary Fund (IMF, 2009, page 21), while revenues of the central budget made up only 42.3 per cent of the GDP in 2005, they grew to 46.8 per cent by 2009 and no significant decrease can be expected in the coming years either. In the same period, expenditures went up from 50.1 per cent to 50.7 per cent. Therefore, it is fair to say that nothing has changed regarding redistribution by the state and if we consider excessive redistribution a problem, then it is still there in Hungary.

◗ *Sustainability:* Indeed, significant progress has been made in respect of budget deficit compared to prior years. According to the International Monetary Fund's forecast, despite the crisis, Hungary's budget deficit will have remained under 4 per cent since 2008 (IMF, 2009, page 21). However, this improvement is still not sufficient to reduce government debt perceivably which is expected to exceed 80 per cent by 2010. High government debt will continue to have a negative impact on growth, mainly because of the crowd-out effect and high taxes that are needed for debt financing.

◗ *Structure and effectiveness of expenditures:* Correction efforts focused to restore equilibrium in recent times pushed into the background the reform endeavours that were aimed at restructuring public finances and improving the quality of public services. Based on the latest statistical data, social benefits paid in cash (which have a negative impact on employment) continued the trend of recent years and grew in H1 2009 as well (Central Statistical Office, 2009, page 3). The rate of productive expenditures, however, is decreasing. In the 2010 budget bill, 50 per cent of the reduction of funding to local governments is planned to be implemented through development cuts while another 31.5 per cent is planned to come from lower public education financing (State Audit Office, 2009, page 31).[35] The combination of these trends is completely conflicting with growth considerations, especially with a view to the fact that funding cuts without structural changes are more likely to cause further financing gaps instead of quality improvement. Therefore, what the steps taken in this area facilitate is rather divergence than convergence.

◗ *Structure and effectiveness of budget incomes:* The changes to the income side seem to be more favourable. The increased ratio of VAT and the simultaneous decrease of income taxes and contributions within budget revenues (IMF, 2009, page 22) can be regarded as steps to improve willingness to work. The decrease of taxation channels and the resulting mitigation of the administrative costs of taxation are also positive. These favourable changes, however, are put into perspective by the fact that according to the latest survey by the World Bank, Hungary's biggest competitiveness problem still relates to its tax system and thus the country ranks no. 122 in the competitiveness rank of a 183 countries, falling 8 positions since last year (World Bank, 2009). Therefore, the measures taken by the current government are assumed to be sufficient only for mitigating Hungary's competitiveness gap and slowing down its divergence.

◗ *Fiscal institutions:* Like with the income side, progress has been made in this area recently. Act LXXV of 2008 on Budget Liability ordered the establishment of the Budget Council and set balance limits regarding government debt and expenditures. Although these measures should definitely be welcomed, they must be evaluated bearing in mind that the setting up of formal institutions in itself did not prove to be a wonder substance in any country and a number of examples show that they did not bring about fiscal discipline (Kopits, 2007, pp. 205–207). Therefore, it is still to be seen whether the new rules can change real-life practices in Hungary. In any case, it is a warning sign that in their assessment of the 2010 budget bill, the State Audit Office (SAO) mentioned the continued lack of impact studies for decisions with a long-term effect as a fundamental deficiency – just like in previous years (SAO, 2009, page 8).

◗ *Business environment:* Based on international competitiveness surveys, the business environment in Hungary kept deteriorating in the past few years (Chikán, 2009). For small and medium enterprises, even the latest surveys name high pubic burdens and administrative costs and the undependability of economic regulations as key barriers to growth (NGFM, 2009, page 16). Although the lowering of taxes levied on labour and the steps towards simplification will bring some improvement in this area, too, these measures are often subject amendment or withdrawal right after they enter into effect (Ministry for National Development and Economy, 2009, page 21). What it all suggests is that the current set of measures did not help much in improving dependability which is a prerequisite of investments while its other impacts cannot be judged yet.

Regarding the qualitative dimensions of fiscal policy, the main conclusion is that only two areas (sustainability and budget incomes) show perceivable improvement out of the six areas examined. These two areas are undoubtedly important as that is where the most severe problems evolved and eroded Hungary's competitiveness in recent years. While acknowledging these merits, however, we must not forget that these are partial areas only which are insufficient to ensure convergence on their own. What is more, without any improvement to the quality of public services, these accomplishments can easily vanish as the overall lack of confidence generates considerable pressure to withdraw the austerity measures and to compensate various pressure groups (Győrffy, 2007b). As it turned out already from the theoretical review, another important assessment consideration is that after the crisis the effectiveness of the public sector might be even more important for a country's competitiveness and growth performance than before.

One common feature of the measures that we have been missing in the qualitative dimensions of fiscal policy is that they cannot be implemented overnight as the improvement of the quality of institutions is a long and complex process. A government with a limited mandate is obviously not in a position to carry out such measures. Despite the acknowledgement of this circumstance, however, we must continue to consider unrealistic all opinions which suggest that the rearrangement of taxes and some expenditure cuts will put everything into order after the crisis and enable Hungary to converge to the EU average. These apparently easy and fast solutions do not work and the issue of development cannot is not so simple – this is what *Csaba* (2008) warned about earlier in conjunction with the Baltic "miracle".

Naturally, fiscal policy inefficiencies deriving from the poor quality of institutions will not prevent either cyclical growth periods or Euro adoption. As illustrated by the example of Portugal, we will actually face the real consequences of weaknesses after Euro adoption

when fiscal policy will be the only available tool for the government to manage potential shocks. Therefore, it is only a hope and opportunity, but definitely not a forecast that the practices of recent decades, i.e. one-size-fits-all reductions and reform attempts based on ad-hoc brainstorming will be replaced by a series of measures that are designed with a multi-year horizon in mind and focus on the improvement of institution quality. Without this transition, lasting relative stagnation is definitely a realistic expectation for Hungary even within the Euro area, meaning that convergence will remain a daydream.

Notes

[1] Examples of these measures include the elimination of 13th-month pension and the introduction of stricter conditions on family support. See measures in detail in the letter of intent sent to the IMF. Downloadable at: http://www1.pm.gov.hu/web//home.nsf/portalarticles/58EE632FC53453D6C125758A004EDE65?OpenDocument Downloaded 29 September, 2009.

[2] This statement is proved thoroughly by Erdős, 2009, pp. 224–227

[3] During the negotiations on the stand-by loan, both the government and the International Monetary Fund predicted that the austerity measures would bring about a boom (IMF, 2009, pp. 8-9). The positive opinion of specialists is also reflected in the first report of the newly established Fiscal Council, saying that the measures will raise the GDP by 1-1.5 per cent in the long run (Fiscal Council, 2009a). In the 2010 budget bill, the government calculates with a growth rate of 3.9 per cent for 2011 while the Fiscal Council forecasts a 3.2 per cent figure for the same period (Fiscal Council, 2009b, page 9).

[4] This learning process is one of the decisive prerequisites of lastingly sustainable fiscal policy. See more based on the experiences of "old" European Union member states in Győrffy (2008).

[5] For a detailed discussion of the endogenous growth theory in Hungarian please refer to monographs by Erdős (2003) and Czeglédi (2007).

[6] The in-depth discussion of this topic would obviously call for an entire monograph and therefore the scope of the sections below must be limited to reviewing the key criteria as opposed to outlining them in detail.

[7] Empirical literature is reviewed and the lack of robust results is presented in e.g. IMF, 2004a, pp. 3–4.

[8] Another difficulty with determining optimum redistribution is that the role of the state is never limited to promoting economic growth. There are other decisive considerations like the mitigation of social inequalities or the protection of those in need.

[9] Concerning the trends of government growth see details in Tanzi, 2005, pp. 619–620

[10] An clear and concise summary of related literature is provided in Afonso et al, 2005, page 23 and Barrios and Schaechter, 2008, page 11

[11] Automatic stabilisers can dampen GDP fluctuations associated with economic cycles without any explicit intervention by the government. E.g. in a time of crisis, less tax income is received by the government and more money is spent on unemployment benefits.

[12] In 2010, weighted average government debt is expected to exceed 100% and 84% of the GDP in OECD countries and in the Euro area (OECD, 2009b, page 122). Csaba (2009) points out the political and interest group-related aspects of crisis management measures. As these implications suggest a lasting stagnation similar to that of the 1970s in the medium run already, the return to a sustainable growth track requires the abandoning of these "crisis management" practices.

[13] Easterly (2005) found that the negative correlation between deficit and growth is only there in case the budget deficit exceeds 12 per cent. Based on findings in developing countries, however, Adam and Bevan (2005) found statistically significant negative effects with a deficit over 1.5 per cent already.

[14] The issue of the crowd-out effect is discussed in detail in Erdős, 2003, pp. 170–176

[15] About further conditions of anti-cyclical economic policy, see Benczes, 2009, pp. 6–8

16 For a more extensive summary of various budget consolidation methods, see Győrffy (2007a) pp. 17–21. An immense amount of literature was generated on budget correction on the income and expenditure side in recent years. A monographic review of this literature is provided in Benczes (2008).

17 The same applies to the budget strategy of individual countries. E.g. in Ireland, crisis management will trigger a debt increase from the 25 per cent in 2007 to nearly 80 per cent in 2010 (European Commission, 2009, page 164). Budget consolidation is a clear goal in the medium-term budget strategy. See Lane (2009)

18 A summary of this is provided by Csaba (2010).

19 For a more comprehensive review of debates regarding the correlation of growth and public investments and for a summary of former empirical literature, see Afonso et al, 2005, pp. 25–27

20 The difficulties of measuring effectiveness are described by e.g. Török (2008) who wrote about methodological problems of higher education rankings.

21 Naturally, it is important to note here that similarly to other economic policy elements, decisions on the tax system are not purely driven by growth and effectiveness considerations. Equity aspects also play a role, even they are not necessarily enforceable in the tax system. See more on this issue in Erdős, 2006, pp. 101–108.

22 Tax wedge: shows the percentage of total labour cost (including levies on both employee and employer) that us taken away by the state in the form of various taxes and contributions.

23 The deficit spending propensity of democracies was first mentioned by Buchanan and Wagner (1977) and later became a widely accepted axiom of the theory of public choices. About the types of rules designed to keep deficit spending propensity under control and about their impact on fiscal performance, see the summary of the European Commission, 2006, pp. 121–168, Győrffy, 2007a, pp. 43-67 and, in Hungarian, Kopits, 2007.

24 According to Lackó (2009, pp. 529–530), the correlation between the tax wedge and employment is not significant in itself, but the correlation between the combination of corruption and tax wedge and employment is significant.

25 Figures are available at the Transparency International website: http://www.transparency.org/policy_research/surveys_indices/cpi/2006. Downloaded: 22 August 2009

26 This supports the arguments of Csaba (2010) on the fact that the crisis does not necessarily have to bering on a paradigm change in economics. Only the dogmatic interpretation of mainstream textbooks must be challenged in real-life economic policymaking.

27 As I will discuss in detail later, these tools obviously provide only a temporary solution to managing competitiveness issues.

28 About financial liberalization in Portugal, see IMF (1998)

29 Naturally, it does not mean to suggest that financial liberalization must be avoided. Instead, the conclusion should be that financial liberalization must be implemented with the simultaneous reinforcement of risk management regulations. See more details on this in Prasad et al (2003).

30 http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb020 Downloaded 24 August 2009.

31 Concerning bubbles originating in excessive lending, see Mosolygó and Szabó (1998) in the context of the Asian crisis, and Drees and Pazarbasioglu (1998) in relation to the Scandinavian crisis of 1991–1993.

32 November 1992: –6 per cent, March 1993: –6.5 per cent, May 1995: –3.5 per cent. Source: Constancio, 2005, page 208

33 In Portugal, government revenues compared to the GDP went up from 1985's 30.1 per cent to 43.2 per cent in 2008, while expenditures grew from 38.8 per cent to 45.9 per cent in the same period. Source: European Commission, 2009, pages 118, 136.

34 About the toughness of laws protecting Portuguese employees and the adaptability of the economy see more in IMF, 2007b, 22–31.

35 In conjunction with the fiscal adjustments of 2007, Szakolczai (2009) criticised the decrease of investment into human capital and that of capital formation, plus the increase of social expenditures paid in cash. Thus his conclusions also apply to the current corrections.

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