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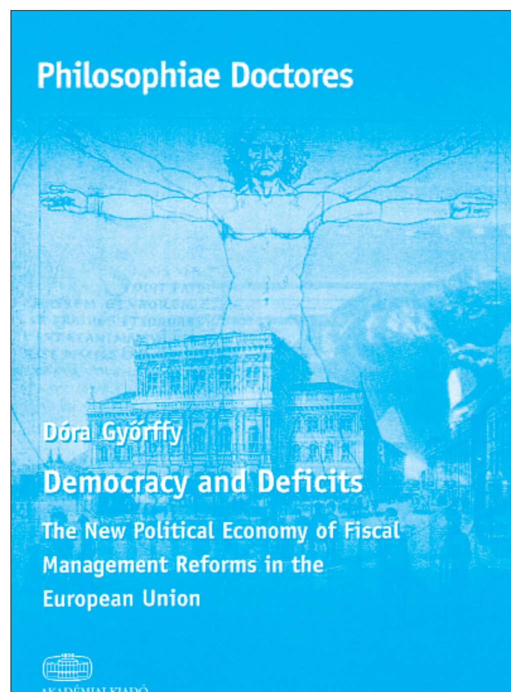
Democracy and deficits

The new political economy of fiscal management reforms in the European Union



Akadémiai Kiadó, 2007

The author was awarded the Ph.D. degree for this work, however, the reviewer believes that the professional quality of this book would have equally justified the award of the doctorate degree of the Hungarian Academy of Sciences.

This book is not only valuable, but relevant, too, and the title itself could not be more topical. It includes the word 'deficit', and at present there are only few topics in the world that are less disputed. It includes the word 'democracy', i.e. the question of political mechanism, and one of the most disputed topics in present-day Hungary is how the political mechanism could lead to such a high deficit. It includes the expression 'new political economy', and one of the most important professional questions of economics is how the broader perspective of this approach can be enforced in research and economic policy alike. The title also includes the expression 'fiscal management reforms', i.e. rules-based budgeting, and the possibility and method of introducing this type of budget policy is currently in the focus of domestic disputes. Finally, it includes 'European Union'; I believe that the topicality of this issue needs no comment. The thoughtful reading of this book is suggested for this reason, but also for its concrete content and recommendations.

A principal merit of the book is its strictly logical structure. The chapters are organically related and lead to a final conclusion. Therefore, I cannot avoid presenting the book chapter by chapter, or even subchapter by subchapter before providing a brief evaluation.

■ *Chapter 1.*, the Introduction sets the tone of the work and determines its frameworks. It starts out from the well-known fact that slowing growth rates and aging populations have led to a rise in budgetary deficits, and to the institutionalisation of fiscal discipline all over the world; the Maastricht Treaty (MT) and the

Stability and Growth Pact (SGP) are typical examples of the latter. Yet it is still unclear why certain countries, such as the Baltic countries and Slovenia can fulfil the requirements of these instruments relatively easily, and why other countries, including the Visegrád countries face considerable difficulties in doing so. Other fundamental economic questions, such as how long the deficit can be sustained, and how deficits might affect economic growth and the sustainability of the growth process have not been explained either.

The most fundamental question that has remained unanswered to date is the relationship of deficit, financial sustainability – i.e. the continuation of the current fiscal policy into the future – and economic growth (Subchapter 1.1.). If a country suffers from deficits, it has several solutions for the problem. It can increase the inflation rate, increase indebtedness, cut back infrastructural and welfare expenditures, increase taxes, or slash public administration costs and various transfers. In general, the governments make use of the above listed tools in the given order. However, emerging deficits can be attributed to three causes or three groups of causes (Subchapter 1.2.). A deficit can be caused by economic reasons, i.e. it can be the consequence of an economic downturn. In most of the cases this explanation is not satisfactory. On the other hand, a deficit can be attributed to political causes, such as political upswing, as well as to fact that politicians are first of all interested in being re-elected and less in economic prosperity or full employment. In addition to this, they are also exposed to the pressure exercised by the different interest groups, and are prone to underestimate the future compared to the present. Unfortunately, this explanation is more realistic, yet it is not satisfactory either. Finally, deficits can be attributed to technical issues, i.e. to the fact that bureaucracy is inherently disposed to increase the budget, or its expenditure side to the maximum. The role of this disposition may increase proportionately to the fragmented nature of the system of budget preparation, i.e. to the number of institutions with independent budgets. If this is true, this is a highly promising approach, since "reforming budgetary management appears a relatively easy task in comparison to health care or education reforms" (page 31). The relevance of this fact and therefore the topicality of this book at the time of writing these lines, i.e. at the end of November 2007, probably need the least justification in Hungary.

These considerations directly lead to the two basic questions to be examined (Subchapter 1.3.): (1) "Under what conditions governments implement a stricter budgetary framework and limit their discretion over fiscal policy decisions?" (page 32) and (2) "In countries where such rules are implemented why do governments with limited mandate adhere to them and forego discretionary spending?" (same page). The same considerations directly lead to the method of answering these questions and the research programme of the book (Subchapter 1.4.). On one hand, "these considerations necessitate a political economy approach, which recognizes the insights of traditional economics but at the same time treats the political sphere as endogenous to the analysis." (same page). On the other hand: "*the method of systemic analysis*" must be applied, which "has a long tradition in economics and its classics include *Marx, Mises, Hayek, Polányi és Schumpeter*" (page 33). However, in the third place it also leads to the fact that: "All potentially relevant factors are taken into consideration initially and then over the research process the number of variables is gradually narrowed by a process of elimination" (page 34).

In this introductory chapter the fundamental principles are followed by the summary of the argument (Subchapter 1.5.), the exact descrip-

tion of the steps of the research procedure, and the outline of the different chapters of the book (Subchapter 1.6.). Finally, the last sentence of this section summarises the final result of the research. "The main conclusion of the research is that the presence of an elite consensus and public trust critically affects the incentives of the government to implement institutional reforms and thus the question of fiscal sustainability cannot be separated from the questions of democratic quality" (page 41). It cannot be disputed that these statements pertain to the Hungarian conditions to a large degree.

■ The introductory chapter ends by emphasising the importance and determining role of the technical aspects and the institutional system; this, as well as the strict logical structure of the book, necessarily lead to the fact that the title of *Chapter 2.* is 'Institutions and deficits'. The introductory section of this chapter emphasises that institutions are "mechanisms [designed] to foster rational decision-making at the individual and collective levels" (page 43). In this relation five basic problems – the five obstacles to rational decision-making – arise, i.e. aggregation, the common pool resource, time horizons, uncertainty and the principal-agent problem. This chapter will be devoted to these issues. However, the author gives the main conclusion in advance again: "institutional reforms can substantially improve the workings of traditional budgeting" [...], but "represent serious constraints on the discretion of policy-makers." [Therefore] "politicians with limited mandate have little incentive to implement [these institutional reforms] in the absence of external pressures" (page 44).

This general review is followed by the discussion of rational behaviour and the rationality of collective decisions, and then by the statement according to which institutions are the rules of the game (Subchapter 2.1.). Going on to the topic of the budget – in a more concrete form – (Subchapter 2.2.), the book describes how the five difficulties discussed before (ranging from aggregation to the principal-agent problem) can cause institutional bankruptcy, and consequently a fiscal deficit. The way out (Subchapter 3.3.) is first of all about setting numerical rules – such as the 3 percent and 60 percent requirements, however "while simple numerical rules are more desirable than complex ones, essentially both types represent a treatment for the symptoms but not for the problem itself" (page 58). The same can be said about independent budget related advice: their aim can hardly be more than compliance with the numerical rules. Irrespective of this, all such measures are useful, because they promote fiscal discipline and the reduction of the deficit, and all of them are compatible with traditional budgeting, too. But here we are at the basic problem (Subchapter 2.4.). If we rightly assume that the primary goal of politicians is to be re-elected, why would they introduce these measures if they tie their hands and may deteriorate their chances for re-election? This means that the 'how?' question leads us to the 'why?' question.

■ In relation to this question, just like at the beginning of the presentation of the previous chapter, one cannot be surprised by the fact that the title of the subsequent chapter, *Chapter 3.* is 'The rationality of self-binding: globalisation and credibility' (page 69). In line with this title, compulsory globalisation and the requirement of credibility would be those elements of the system of correlations that would make politicians take the necessary measures. This would be the required "external pressure" discussed previously (page 44).

If the external pressure is represented by the world economy, or globalisation, the open-economy trilemma arises immediately (Subchapter 3.1.): "a country [with an open economy] cannot have simultaneously free

flow of capital, independent macroeconomic policy to support full employment and fixed exchange rate" (page 71). This obviously true statement is followed by the overview of the currency systems of the past 150 years, within which the system of the gold standard is mentioned briefly. The collapse of the Bretton Woods system and the crude oil crises in the period of 1972–79 were followed by the emergence of high budget deficits all over the world (Subchapter 3.2.), because the growth rate of revenues dropped in parallel with the reduction of the growth rates of the economies, while the growth of expenditures did not slow down. Instead, it accelerated and the balance could be restored – in many but not all countries – only in the early 2000s. The relevant figure and table published on page 76 and page 77, respectively, are very instructive.

After Bretton Woods (Subchapter 3.3.) "the leaking capital controls meant that the choice over the trilemma narrowed from three to two options: macroeconomic autonomy or fixed exchange rate" (page 78), and "the negligence of long-term considerations in public finances was further reinforced by the availability of foreign savings with the gradual liberalisation of capital markets" (page 79). This situation led to the emergence and importance of the terms vulnerability and credibility, and the lack of credibility has led to the delegation of "[budget related] power to an independent institution, which does not share the short-term incentives of the government" (page 87). We have again arrived at the international pressure that was discussed above and that has led to the global spread of rules-based budgeting (Subchapter 3.4.). The same thought is carried on by the explication that closes this chapter (Subchapter 3.5.): "The worldwide spread of fiscal rules supports the argument about the disciplining force of international financial markets" (page 92).

■ However, Hungary belongs not only to the world economy, but also to the European Union, wherefore the Hungarian situation and economic policy are strongly affected by the European developments, too; *Chapter 4.* reviews these correlations. It is well know that the Maastricht requirements and the Stability and Growth Pact (SGP) formulate numerical objectives, and two completely contrasting hypotheses can be formulated in connection with their efficiency. According to one hypothesis, the deficit has decreased under their effect, compared to previous periods. However, according to the other hypothesis, the insufficient enforceability of the Pact and the related insufficient credibility refer to the fact that the EMU reduces the coercive effect of the international pressures aiming to strengthen the fiscal discipline by suggesting a greater sense of security than the member states could generate based on their own situation.

This chapter reviews the original objectives and possibilities of the SGP (Subchapter 4.1.). It is an obvious fact that the financial difficulties of the individual member states have externalities to other members, wherefore every member state is interested in preventing the aggravation of the financial difficulties of the other member states. However, EU legislation bans explicit bailout from financial difficulties. Yet, ex ante bailout does exist, in the case of which the European Central Bank (ECB) keeps the interest rate low in order to reduce the financial difficulties of certain member states. Similarly, ex post bailout occurs, when the ECB buys large volumes of a member state's bonds on the secondary market. Both practices are costly and detrimental for the rest of the member states. However, all this leads to the fact that the international financial markets react to the financial disturbances of the individual member states only in extreme cases, and the smaller faults of certain member states – or possibly the larger faults of the small member states, one may add – go unpunished. By adding the reviewer's opinion to the book

review, this may have led to the recent attitude of the international financial community towards Hungary, and – coming back to the arguments listed in the book – this may have led to the situation that the EMU must strive for, and is striving for the enforcement of fiscal discipline in the member states.

Although the success of these EMU efforts can be disputed (Subchapter 4.2.), one can nevertheless conclude that "in comparison to other large currency areas such as the US and Japan, the EMU countries show considerable restraints especially during slower growth periods." As a result, "although the effect of the EMU fiscal framework is at best questionable […] its monetary arrangements can be considered a clear success" (page 100). "The establishment of the common currency can be considered successful in terms of increasing the credibility for economic policies" (page 102). However, it has a negative impact, too, because, "at the same time it can also become a disincentive to reforms because the credibility of the common currency provides considerable protection from market forces for members and candidates of the EMU. Consequently these countries experience only the opportunities from the availability of foreign savings rather than the risks from the global financial markets" (page 103). It is almost unnecessary to point to the evident Hungarian relevance of these statements. This situation also leads to the fact that by the financial circles "the pressure from the EU is still viewed as the prime factor, which is likely to bring about fiscal consolidation" (page 104), which can also imply the fact that "Hungary will not want to join the Euro zone later than the neighbouring countries" (same page).

These conclusions are reinforced by the analysis of the impacts of the EMU on the domestic system of financial institutions (Subchapter 4.3.). As a result, "virtually all [new EU member states] have taken steps towards improving their budgetary management practices" (page 108). Consequently, it can be stated (Subchapter 4.4.) that the Stability and Growth Pact "did not prove to be a stronger and more effective disciplining device than the market forces it intended to support. […] It proved to be a useful anchor in countries, which have started fiscal adjustment, but at the same time it weakened incentives for reforms for those countries, which had not started the consolidation process. [...] The inadequacy of international pressures to bring about fiscal adjustment underscores the importance of domestic factors in fiscal reforms" (page 110).

In line with the strict internal logic of the book, this statement directly leads to two country studies, the Hungarian and the Swedish cases. In Hungary the domestic circumstances have proved to be stronger than the international influences, and no proper fiscal reform has taken place yet. However, Sweden has turned out to be the most successful in this respect among all the developed countries. The next two chapters present these two country studies.

■ *Chapter 5.,* which deals with Hungary, starts with the statement that "in November 2005 the Council of the European Union issued its second warning to the Hungarian authorities about the presence of an excessive deficit and declared that the efforts to decrease the budgetary imbalances had been insufficient. In the justification for issuing the warning the Council reported the decision of the Hungarian government about not taking further measures to correct the excessive deficit" (page 111). The author goes on saying that "the open resistance to European pressures by a small new member state [clearly] shows the limited effectiveness of the EU disciplining mechanism when domestic forces work strongly against it" (same page). The obvious aim of this chapter is to explain how this is possible. "What are the specific domestic factors that

lead to an open resistance to international pressures? What makes international pressures ineffective?" (page 112)

Similarly to the previous chapters, the author gives the answer already in the introduction: "the resistance to fiscal consolidation in Hungary can be attributed to the low level of public trust towards the elite, which is the result of the considerable continuities from the communist era. […] As long as the expectations about eventual introduction of the Euro remain strong on the financial markets, the country is protected from such [a larger] crisis by the EMU fiscal framework and thus overspending is likely to persist" (same page). The author deserves the greatest appreciation for the brave and unambiguous statement of these propositions.

This introduction makes the detailed presentation of the rest of the chapter almost unnecessary. It is all the more so because here the author mostly relies on well-known domestic literature. First she presents public finance in Hungary in the period of 1957–2005 (Subchapter 5.1.). The figure on page 122, which presents the growth of real wages over the growth of productivity in the years 2000 to 2003 deserves special attention, just like the table on page 125, which shows changes in the twin deficit in the years 2001 to 2005. Then the chapter discusses the continuities of the communist period and the current years (Subchapter 5.2.). It points to the fact that the basic problem has remained the same: the authorities had to choose between "lowering living standards or overspending" (page 126) then, and they need to do the same today, and neglecting "the long-term interests of the country" can be attributed to "the general level of trust and elite relations" (same page). These problems are significantly aggravated by "high unemployment", "sharp increases in inequality" (page 127), "the moral crisis of democracy" (page 128), as well as "the dominance of the old technocratic elite" (page 129). The only exception was the successful stabilisation process in 1995, however that was associated with unique causes. The author pins little hope on breaking this inertia. (Subchapter 5.3.). Finally she states the logical final conclusion (Subchapter 5.4.): the detailed analysis reinforced the initial assumption. "The most important message is that a certain degree of trust in the regime and within the elite is critical for consolidation and sustainable institutional change. Without these conditions economic populism and short-term thinking are likely to dominate the long-term interests of the country" (page 137).

■ In these aspects Hungary is the negative example, while *Chapter 6.* indicates that Sweden is the positive example. According to the author, it requires thorough explanation why this is so, because the two countries are similar in many dimensions. Both are small, open economies with a large state redistribution. At the same time, the extremely proportional Swedish electoral system, which regularly yields a minority government, is in theory less favourable for the reforms than the Hungarian system, and in the first approach it would suggest that solving the problem is more difficult in Sweden than in Hungary.

First the book gives an overview about the initial situation, about the Swedish economic developments in the period of 1920–2004 (Subchapter 6.1.). The Swedish model came into being as a consequence of the Great Depression – which is a well-known fact – and its basic principles had enjoyed great social consensus since the very beginning. The model eroded in the 1980s, when the public sector's share grew disproportionately large in employment, and budgetary expenditures exceeded budgetary revenues. This erosion deepened into a crisis in the 1990s, when the rate of Swedish unemployment grew to the nearly unbelievable 10 percent (page 152). This crisis was followed by consolidation, the efficiency

of which is well indicated by the summary table (page 153). Between 1994 and 1998, budget revenues grew from nearly 60 percent of the GDP to 62.5 percent, while expenditures dropped from 70 percent to 61 percent. This meant that not only primary, but general budgetary surplus was generated in four years, which is an unparalleled success. "The experience of Sweden becomes particularly interesting once we consider that many of the elements of the welfare state are still maintained and state redistribution continues to remain well over 50 percent of the GDP. This shows that the large size of the public sector does not need to involve sizable deficits. After the improvement of finances, many of the transfer provisions that were reduced earlier, were restored without endangering the sustainability of finances." What's more: "The strong commitment to a comprehensive, universal and generous welfare state also implies that taxes could not be cut to the extent envisaged by early globalisation theorists, who argued that with capital mobility the scope for taxation remains limited as capital moves where it can ensure the highest return" (pages 154 and 155).

These results are mostly the consequences of the rules-based fiscal policy (Subchapter 6.2.), since traditional budgeting largely contributed to the emergence of fiscal imbalances in the 1970s and the 1990s. The growth of public debts – shown in the figure on page 158 – from 20 percent of the GDP in the period of 1965–1975 to over 80 percent of the GDP by 1995 (which was an astounding and unprecedented figure for Sweden) was largely attributed to this. In response, the government – justifiably – earmarked a general budget surplus equalling 2 percent of the GDP, and it reached the target as it was presented previously. This success was largely due to the top-down budgeting technique, i.e. to the fact that the government starts out from the available sum and the distribution thereof, instead of the needs and the total thereof, as well as to the fact that "if spending is increased in one area, it has to be decreased in another area" (page 159). Summarising the conclusions of the two subchapters one can say that instead of liquidating the welfare state, the Swedish government solved this problem by modifying its budgeting technique, and curbing the really unnecessary expenditures, which is an immeasurably important experience for Hungary.

The overview of the political economy correlations of the reform (Subchapter 6.3.) leads to relatively simple consequences. The international factors and the EMU had a negligible role, since the overwhelming majority of the Swedish population rejected the common currency. Instead, the domestic factors played a determining role, and the author discusses in length the achievement of consensus within the professional elite, and then within the society, in which Swedish economists, who had traditionally been involved in policy making, played a crucial role. "Overall while elite consensus was the critical factor behind the implementation of a rules-based fiscal policy, public trust in the system, ensured by the success of the reforms, the material benefits of the welfare state as well as the low level of corruption, is critically important for [the creation of] sustained fiscal restraint" (page 171). Hence, maintaining the welfare state is more of a precondition for than an obstacle to fiscal discipline and the balanced budget – adds the reviewer his own opinion to the author's conclusions. This chapter ends with the brief summary of the conclusions (Subchapter 6.4.).

Chapter 7., which can be regarded as the most important part of the book, describes the Swedish and Hungarian experiences in general, and draws the conclusions therefrom. As it could be seen in the previous chapters, the author expresses the final conclusion in the introduction: "Fiscal governance reforms can take place only if there is a broad elite consen-

sus on the importance of fiscal restraint. The effectiveness and sustainability of these institutional reforms is crucially dependent on the continued maintenance of the original consensus, which in turn is shaped by the perception of the public on the general quality of the democracy" (page 173).

First of all, this chapter gives an overview about the pressures for fiscal reforms (Subchapter 7.1.). The sections on the international and European influences basically repeat the opinion expressed earlier. The description of the domestic influences makes the basic conclusion pertaining to Hungary even more concrete: "In the context of the Hungarian case, […] the sharp divide in the elite gave rise to a prisoner's dilemma situation with respect to fiscal spending: while both major parties would be better off with more responsible electoral promises (once they are in government), the lack of cooperation between them results in an exponential increase of populist promises before elections" (page 177). Furthermore: "The case of Hungary provides a telling example about how incentives for overspending emerge for all actors in a low-trust environment. The section on the implementation of fiscal reforms (Subchapter 7.2.) distinguishes four steps: the recognition of fiscal problems, fiscal consolidation, the institutionalised consensus on fiscal restraint and finally institutional sustainability. For the last step, the awareness of the voters is extremely important, i.e. the electorate should know that "current overspending has to be financed by future surpluses" – i.e. by future constraints (page 182).

■ However, the most important explications are contained in the next section (Subchapter 7.3.). According to them, two basic variables can be distinguished:

- *Consensus:* "regardless of which political parties form the government, economic policy is conducted with a commitment to fiscal restraints" (page 183), and
- *Public trust:* "public belief that the political regime produces 'good outcomes'" (same page).

These two basic variables lead to the definition of two propositions:

- *Proposition 1:* "Fiscal institutional reforms take place only if there is a consensus within the political elite" (page 184), and
- *Proposition 2:* "Fiscal institutional reforms can be sustained only if the original consensus during their establishment is sustained" (same page).

Based on these considerations, four basic states can be defined:

- *the democratic ideal:* in which both consensus (within the elite) and public trust exist;
- *the liberal democracy:* public trust is present, but there is no consensus;
- *the philosopher's state:* consensus is present, but public trust is missing;
- *mass democracy:* there is neither consensus, nor public trust.

Apparently, the main conclusion is that in the case of the democratic ideal rational policymaking and anticipatory reforms become possible, and the virtuous circle of fiscal restraint-growth-public support can emerge. However, in the case of mass democracy, when there is no consensus within the elite, and there is no public trust towards the elite, "reforms […] are next to impossible" (page 187). The author does not explicitly state it here, but obviously this is what the Hungarian situation looks like. Nor does she write that a way out from this situation can only be found by establishing consensus and public trust, which is obvious based on the content of the book. Nor does the author write what can make the establishment of the missing consensus and public trust possible. However, it is apparent that under such circumstances finding such a solution requires real political genius.

The statement of these principles is followed by a statistical analysis. Based on the

figures of the EMU countries it can be shown (Subchapter 7.4.) that the larger the public trust the smaller the budget deficit is, and the more probable budgetary surplus is. Statistically analysable data are available for the new EU member states, too (Subchapter 7.5.). Public trust in these countries is considerably lower than in the EU-15, and is generally decreasing – especially in Hungary -, and where it is substantially growing (in Estonia and Slovenia), the budget is in surplus. Finally, the comparison of the old and new EU member states (Subchapter 7.6.) clearly leads to the conclusion that the smaller a country, the greater the public trust, and greater welfare leads to greater public trust, which is easy to understand. This chapter leads to the final conclusion (Subchapter 7.7.) according to which "in approaching the question of fiscal deficit as well as institution-building political and economic variables cannot be separated from one another and solution to fiscal sustainability can be found only within a broader integrated framework" (page 200). This means that the approach of the new political economy is needed.

■ The last chapter of the book *(Chapter 8.)* summarizes the results. "The main conclusion is that ultimately it is the perceived quality of the democratic system, which determines whether fiscal restraint is sustained or not […]: while in a high-trust environment fiscal restraint, growth and public trust reinforce one another, in a low-trust regime even if the international environment triggers an adjustment, pressures for overspending are likely to reemerge as politicians are pushed towards buying support through short-term promises" (page 202). Then this chapter refers to the Swedish and Hungarian examples again (Subchapter 8.1.), and reiterates that international and domestic, economic and political aspects alike need to be taken into consideration, which requires the integrated analysis of international economics, globalisation, the Keynesian macroeconomics, the political culture and interest groups. The title of the last section (Subchapter 8.3.) is the same as that of the book: 'Democracy and deficits'. These two topics are strongly correlated and "a virtuous circle can emerge among these concepts, when economic policy credibility, high growth and public support reinforce one another" (page 212).

This book review can hardly contain any criticism or comments, since the reviewer fully agrees on virtually everything with the author. Reading the detailed review, which contains numerous literal quotations, does not substitute reading the book. Rather, it may facilitate reading and may make the details more understandable by giving a preliminary general overview. It seems to be necessary to add one substantial remark, which can be most easily done in reference to the last sentence of the book, although it also pertains to previous sections of the book. Here the author writes that the credibility of politics implementing the fiscal reform, high growth and public support, i.e. public trust reinforce one another. This is certainly true, but what happens if the fiscal reform goes together with restrictions and economic setback, or if it induces setback. How can setback be mitigated in this case and what efforts are needed to overcome the deficit? What is the correlation between the financial and the real sectors, as well as between the two branches of the twin deficit? These questions must be naturally studied even if a book cannot be judged based on what it does not include, since no book can contain everything. However, I can do nothing but agree with what is put forward in this book.

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